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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1987

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1987

FEBRUARY 18 AND 19, 1987

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1987

WEDNESDAY, FEBRUARY 18, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Shelby, Graham, Heinz, Hecht, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. We begin this morning with the most important oversight responsibility carried by any committee of Congress, that of reviewing the monetary policy of the Federal Reserve Board of Governors. Why is this responsibility so enormously important? First, the monetary policy of the Federal Reserve and its implementation have profound and far reaching effects on the economic wellbeing of our country. Second, our responsibility is dictated to us by no less an authority than the Constitution itself in article I, section 8, subparagraph 5. That provision states that only the Congress shall have the power, "To coin money and regulate the value thereof."

During the nearly 30 years that this Senator has served on the Senate Banking Committee, there has been little doubt about the high quality of the Chairman of the Federal Reserve and their very professional staff. And there is no doubt about the remarkable ability of the current Chairman or his staff. Indeed, Chairman Volcker is viewed by this Senator as one of the most talented of those giants who have so wisely guided the critical money and credit aspects of our economy.

Doubts arise not in regard to the Federal Reserve's leadership but in regard to a monetary policy that seems increasingly out of control. This Senator is concerned that the rapid growth of monetary reserves exceed prudence. This growth is unwise in view of the inflation potential residing in dollar exchange rate declines, energy price increases, and Federal spending imbalances. Realization of this potential accompanied with continued rapid money growth can have over time only one sure result—inflation—the result of too much money chasing too few goods. In an economy as debt burdened as our own is, the further consequence of an up trend in in-

flation will be a skyrocketing of interest rates, followed by a sharp economic slowdown, and rapidly increasing unemployment.

To weigh these and other risks, we have with us this morning a panel of experts of international reputation. Mr. Axilrod, it is my understanding that this may be the first time that you have appeared before a Congressional Committee to discusss monetary policy. In light of your long professional role as the top staff official at the Federal Reserve responsbile for monetary policy development and implementation, your appearance this morning is particularly significant. Two of our other witnesses, Mssrs. Erich Heinemann and Allen Meltzer, on the other hand, have served for many years on the Shadow Open Market Committee as critics of the same policies Mr. Axilrod implemented.

To make this Australian Tag Team match even more exiciting, Mr. Lawrence Chimerine of Chase Econometrics comes to us as a widely respected critic of Reaganomics—the very policies Mr. Paul Craig Roberts, our last witness, in part authored and now vigorously defends.

Together these witnesses represent a wide range of views on monetary policy regarding both its domestic and international dimensions. We are very fortunate to have them here this morning and look forward to the benefit of their testimony.

Senator Hecht, do you have a statement you would like to make?

Senator HECHT. No, thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. I thank you.

Mr. Chairman, I am pleased to be here this morning as the committee begins its oversight hearings on the Federal Reserve's First Monetary Policy Report for 1987. This hearing comes at an uncertain time for the U.S. economy. Inflation has been low, but the latest wholesale inflation figures are up. Economic growth is low and we seem to be using only about 80 percent or less of our factory capacity, yet the stock market continues to move from one all-time high to the next almost daily. The dollar has declined precipitously, which should help our exports, yet imports continue to grow, and our trade deficit has, at least so far, failed to show noticeable improvement.

There also seems to be some real uncertainty as to what the Federal Reserve's policy is, and what it should be. Some point to the fact that M1, the most basic measure of the money supply, has been growing very rapidly in recent months, and argue that the Federal Reserve should keep a tighter rein on the money supply. Others, looking at the low growth in GNP, say that the Federal Reserve should conduct monetary policy in a way that will stimulate higher rates of economic growth. They believe the fed can accomplish this objective without reigniting the fires of inflation.

The witnesses before the committee this morning are all distinguished economists. I look forward to hearing from them on the issues I have mentioned, and on other issues related to the conduct of monetary policy. I also look forward to hearing from the Chairman of the Federal Reserve, Paul Volcker, tomorrow.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. I have no opening statement, Mr. Chairman.

The CHAIRMAN. Well, we'll start alphabetically with Mr. Axilrod and go right across and end up with the cleanup hitter, Mr. Roberts.

Mr. Axilrod, go right ahead, sir.

STATEMENT OF STEPHEN AXILROD, VICE CHAIRMAN, THE NIKKO SECURITIES COMPANY INTERNATIONAL, INC.

Mr. AXILROD. Well, thank you, Mr. Chairman. It's somewhat daunting to be at this table after so many years of the comfort of sitting right there behind and letting other people taking the brunt.

This is not as you know a simple time for monetary policy by any means. In 1979——

The CHAIRMAN. May I just say—and this won't be taken out of your time—that each witness will have 10 minutes and then the red light will go on and then we'll have to terminate it. And if at the end of our hearing you would like to state anything that you would like that's been left out, you'll have 2 minutes to do that.

Mr. AXILROD. Thank you. 1979 was, in some sense, was simple for monetary policy because it was clear that the objective was to control inflation and what needed to be done had to be done.

In 1982, it was very clear that inflation was to a reasonable degree under control and recovery from recession had to be the prime objective.

More recently, objectives have been much less clearcut and the Fed has necessarily had to strike a much finer balance between the need to encourage growth and the need to contain inflation. And they have, in my view, been encouraging growth with relatively rapid expansions in money and liquidity, but I don't believe at this point excessive, and they have attempted to contain inflation by maintaining a degree of pressure on short-term interest rates. In real terms, after allowing for price increases, the level of short-term interest rates is much higher than it was in the inflationary period of the 1970's and about where it was in the less inflationary, almost noninflationary period of the 1960's.

RECENT EVOLUTION OF MONETARY POLICY

More recently, the evolution of monetary policy has been quite complicated by the twin deficits with which everyone is familiar—the large rise in the trade deficit and the large rise in the budget deficit.

The margin of error for monetary policy has become increasingly narrowed as we move into a period when these deficits will necessarily be unwound.

The trade deficit is going to be unwound either deliberately through acts of policy or through market developments because the world simply is not going to accept a continuing outflow of dollars of $150 billion or so a year. When a commodity gets in oversupply, its price goes down and the price of the dollar has been dropping sharply on exchange markets since early 1985.

At some point, this means our trade deficit will be reduced in real terms, and I think that process is beginning right now. At least the trade deficit has stopped rising, is leveling off, and I would expect it to begin declining soon.

The drop in the exchange rate, then, provides an expansionary impulse to the economy but it also provides an inflationary impulse to the economy. So it's a double-edged sword.

I don't have to explain to this committee, Mr. Chairman, the basic reasons for reducing the budget deficit and I will not. But I should emphasize in the context of the trade deficit that it's very important to reduce the budget deficit because that will release financial resources, it will release savings in this economy, and it will release real resources that can be shifted into the international sectors.

As that happens, it will reduce the potential inflationary consequences of the reduction in the trade deficit. It will take pressure off the balance of saving and investment and it will take pressure off our labor, plant, and product markets by releasing real resources through restraint on Government spending.

So I regard the reduction in the budget deficit as a necessary counterpart of the reductions in the trade deficit. If the deficits are phased down together, there will be much less pressure on monetary policy. If the budget deficit is not reduced, for instance, there's an even greater inflationary potential in the expansion of our international sectors.

The behavior of the two deficits is not the only circumstance currently affecting our economy. A lot depends on whether the economy as a whole can be viewed as unusually strong or relatively weak. In a relatively weak economy, for example, there is less pressure on the budget deficit as a needed offset to the reduction in the trade deficit.

One way of assessing the structure of the economy is to look at whether existing credit conditions in themselves are a propulsive force in the economy. To do that, you can't quite look at the nominal level of interest rates; you have to look at the nominal level of interest rates less price increases and less expected price increases to see if in real terms interest rates are high or low.

The Federal Reserve can affect short-term interest rates. Long-term interest rates are somewhat influenced by their actions but essentially depend on market attitudes.

The short-term interest rate in nominal terms has been fluctuating a bit recently, but it's somewhere in the 6 to 6.5 percent area. Very recently, price increases looking over a 2- or 3-month period, short term, are 3 percent or something like that. So you have a level of real short-term rates at 3 or 3.5 percent. That, as I think I mentioned earlier, is much higher than in the 1970's when we were around zero all the time and it was an inflationary period, but it's probably very close to where we were in the 1960's, which was for most of the period a noninflationary period.

So I would say that there's nothing in the level of real rates at this point to act as a strong propulsive force in the economy. In practice, the question is whether they are about right or excessively restraining.

Unfortunately, at this point, Mr. Chairman, I have to revert to my past as an economist and say it's not particularly clear whether they are now about right or excessively restraining.

RECENT ECONOMIC DATA

The recent economic data that has been coming in are not really too bad. The employment figures have been relatively strong and the new orders figures on durables have been in some sense surprisingly strong, although there the tax situation has complicated interpretation.

I personally would expect, looking about a year ahead, that consumption growth will slow because the personal saving rate will probably begin rising back toward somewhat more normal levels. Moreover, I don't see in the housing market very much lift and in certain areas of nonresidential construction we are well overbuilt for many years.

That simply means that basically we have to count on the international sector for most of this year's economic dynamic. There, the drop in the exchange rate certainly helps. But in that respect we also do need expanding markets abroad to receive the goods which our manufacturing industry is increasingly being able to produce on a competitive basis.

There is an inflationary potential, of course, in the drop in the exchange rate. And we do have plenty of liquidity in this economy to sustain that potential should it actually develop out of either the drop in the exchange rate or other forces.

Inflation would reduce real interest rates and stimulate the economy in the short run. But it is a very unsatisfactory way of reducing real interest rates. It is very nonproductive for the long-run health of the economy, and would require strong, quick countervailing monetary policy action. But we don't have evidence yet of an upsurge in inflation.

There is also a potential for economic weakness in current circumstances, Mr. Chairman, if the turn to fiscal restraint here not be accompanied by efforts of other countries to expand through fiscal stimulation or if the basic spending forces here don't in any event have sufficient dynamism. In that case, I would expect the interest rates in the markets, the nominal interest rates, to begin declining on their own. Indeed, there are circumstances under which monetary policy itself might well take the risk this year of shifting the balance between accommodation and restraint more toward the easing side, becoming a little more willing to lead nominal rates down.

Stability for the dollar on exchange markets would be a sine qua non since it would stabilize inflation expectations. In such a circumstance and especially in the context of a restrictive Federal fiscal policy, a tilt toward market ease rather than restraint is less likely to have the counterproductive effect of stimulating inflationary attitudes.

But any such tilt this year, when there are doubts about the extent of inflationary potential, would also require clearer signs that real economic growth is in fact in the process of faltering. Moreover, such a tilt should be buttressed by a little more reliance

on the monetary aggregates, especially I would say M2 at this point, though still viewing that aggregate in the context of the whole group of money measures.

I have about 1 more minute, Mr. Chairman. Under current circumstances, the aggregates might in any event be given a little more prominence in policy, most particularly if the economy does not soon show indications of weakness. The essential reason is because of uncertainty that market forces, as embodied in labor, goods and world commodity markets, will in and of themselves be working to reduce inflation further and because of the nonnegligible risk that inflation could go higher.

In a period of sharply declining inflation and inflation expectations, the aggregates are not really an adequate guide to monetary policy as we have seen in recent years because of related very large and basically unpredictable changes in interest rates and attitudes toward money. But when inflation stabilizes or threatens to rise, the aggregates become a more useful guide simply in the sense that they can then act like a governor on the fuel system.

I should hasten to add, however, that if we do succeed in bringing inflation below 3 percent on a sustained basis—and it's not clear whether that can be done in an orderly fashion or whether it will require a period of economic weakness to do so—a substantial further decline in nominal rates, both short and long term, is at some point ahead of us.

That decline would have to be accommodated, if not encouraged, by monetary authorities, regardless of the behavior of the aggregates, if we are not to prolong the weakness unduly. Thank you.

[The complete prepared statement of Stephen H. Axilrod follows:]

financial markets and certain economic sectors, the economy would probably rather soon weaken in the process of controlling inflation.

I should hasten to add, however, that if we do succeed in bringing inflation below 3 percent on a sustained basis, a substantial further decline in nominal interest rates, both short and long-term, is at some point ahead of us. That decline would have to be accommodated, if not encouraged, by the monetary authorities more or less regardless of behavior of the aggregates in the transition if we are to avoid, or minimize, an undue prolongation of economic weakness as inflation expectations ratchet down another notch or two.

SHA/jo

The CHAIRMAN. Thank you very much, Mr. Axilrod. As I said, for the benefit of those who have come since then, this is the first time that somebody in your position as the top man on monetary policy for the Federal Reserve and implementing it as a staffer has appeared before a congressional committee and testified. I think it's very helpful to have you appear today and this fine testimony.

Would like to extend our welcome to Senator Bond, formerly Governor Bond, now promoted to the exalted position of U.S. Senator. We're delighted to have you with us. You have an excellent background and it's going to be great to have you on the committee. We're very happy to have you.

Senator BOND. Thank you, Mr. Chairman. I'm certainly looking forward to it.

The CHAIRMAN. The rules are that each of the witnesses will have 10 minutes, then we'll have 5 minutes for each of the Senators to question, and we'll have whatever number of rounds necessary. This is the one panel we have today. We go back and forth and after I question, Senator Hecht will then question and then Senator Dixon and so forth, in the order in which they arrived.

Mr. Chimerine, go right ahead, sir.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Dr. CHIMERINE. Thank you, Mr. Chairman. I get the feeling you're trying to set an example for the Federal Reserve by limiting our time this morning so I'm going to get right into the subject because I do have a lot to cover.

I would like to focus on two areas. No. 1, the current economic situation; and, second, the implications for monetary policy.

SLOW ECONOMIC GROWTH

I think everyone in the room is well aware of the recent economic performance in this country. We have had extremely slow growth now for the last 2½ years. As a result, the level of economic conditions, in my judgment, is far from satisfactory. Many parts of the country are still experiencing recessionary conditions. People on Wall Street probably think this is the greatest boom in history, but you don't get quite the same feeling in Moline, IL or Sioux City, IA, or lots of other places that I travel to.

It's a very mixed economic situation and, quite frankly, the health of the economy, in my view, has been consistently overstated during the last several years.

There have been some stronger statistics recently which are leading to the view that the economy is finally starting to pick up, and that the second leg of the economic boom is finally developing.

I would caution against such a conclusion. I think the recent data are distorted by tax reform related activity, and by technical problems with the data. Some industries clearly are picking up. Others, if anything, are experiencing more weakness now than they did several months ago.

It is a mixed bag primarily because the economy is in transition. Some of the industries that are benefiting from the weaker dollar are doing a little bit better but retailing, construction, and others are slowing.

On balance, in my view, the current economic situation basically is the same as it's been now for 2½ years—no evidence of recession, but no meaningful evidence of an acceleration in economic growth. I think we're still stuck in this slow-growth mode that we've been in since the early summer of 1984.

And, when you look at the underlying fundamentals, the approprate conclusion, at least in my judgment, is that this pattern of slow growth is likely to continue for several more years at least. I think the dominant factor in the outlook for the economy remains the trade situation—not only what will happen to the trade deficit itself, but the underlying causes of the trade deficit and what the solutions will do to the rest of the economy.

In my judgment, the major reason we have large trade deficits in this country is because the competitive advantages and productivity differentials that the United States had over the rest of the world during the 1950's and 1960's when we dominated the world economy have been narrowed dramatically. Other countries can now do the same things we can do. They can produce the same products, and in many cases of better or equal quality. They have access to the same mass production capabilities and use the same technology as we do.

But of course, in many of these countries, wages are a fraction of what they are in the United States. When we dominated the world economy we raised living standards in this country by increasing wages and developing corporate structures which, quite frankly, we could afford in those days based upon the productivity differentials which existed, but they don't exist any more to the same extent. They have been narrowed dramatically and, as a result, we have become the high-cost producer in many industries and this situation is fundamentally what has produced the large U.S. trade deficits.

I think the trade deficit will eventually come down. As Steve Axilrod said, it has to. The world won't keep accepting all of these dollars. But the problem is that the solutions that are being implemented right now are not cost-free solutions. Cutting wages, laying off high-wage workers, and pushing the dollar lower and lower, which are the solutions that are now taking place, will all hold back living standards and consumer spending in this country. They are already beginning to squeeze consumer purchasing power and

we are now in the early stages of a sizable deceleration in consumer spending because of stagnating real incomes, high debt burdens, low savings, and the shift in the job mix away from high-wage jobs to low-wage jobs. Second, most companies are still trimming back their investment budgets—real interest rates are high; they have lots of excess capacity and they have lost the investment tax credit.

Construction is coming down because of all the overbuilding. Government spending is slowing.

So yes, I think we will get a modest improvement in the trade deficit. Some industries are already experiencing it. But domestic demand is slowing dramatically and, as a result, when we add it together, it is unrealistic, in my judgment, to expect an acceleration in overall economic growth. The components are changing, and will continue to change, but not overall grants.

WORLD ECONOMY IS FRAGILE

Next, I think the world economic situation is extremely fragile. We have a world economy that is growing slowly at best. Conditions are weakening in Japan and Germany, and in many other areas. Severe recessions are occurring in Mexico, some OPEC countries and Africa. Most of the world is pursuing restrictive fiscal policies. Many countries are also pursuing restrictive monetary policies. Overcapacity exists almost everywhere. Investment is coming down and everybody seems to be engaged in competition cost-cutting, which is designed to increase their share of a stagnant pie, so to speak.

As a result, I think there is a greater risk of a worldwide downturn now than there has been in a number of years.

And third, while I understand the chairman's concern about inflation, I think the inflation risks are minimal at the moment. We are moving into a higher inflation zone because we won't be seeing the sharp decline in oil prices we had last year and because the weaker dollar is pushing up import prices.

However, I don't see the conditions under which this is going to lead to a typical kind of wage-price spiral. Quite the opposite—wages are still being cut in most industries; we have massive excess capacity, both here and abroad; and commodity prices, partly because of oversupply conditions and partly because of sluggish demand, are coming down again.

So it seems to me the increase in inflation will be modest at best. It will take place principally from external sources—namely, the decline in the dollar and somewhat higher oil prices, and it's not the kind of inflationary spiral that I think should cause any great concern.

If this setting is correct, and when you take into account a number of other factors—principally that I think the impact of monetary policy on the economy in this environment is not symmetrical because of the high debt burdens we have and because of all the over-building and excess capacity—modest declines in interest rates stimulate the economy only to a very limited extent, but I think if we do the opposite—if the Fed were to tighten and push up interest rates, it would slow the economy even further.

Statement of

Stephen H. Axilrod, Vice Chairman
Nikko Securities Co. Int'l, Inc.

Over the past two years or so, the Federal Reserve in the conduct of monetary policy has had to cope with a rather more complicated situation than in earlier years. In 1979, it had been very clear that inflation was the principal threat. In 1982, it had become clear that recovery from recession should be the prime objective. More recently, the situation has been much less clear-cut, with the Fed forced to strike a finer balance between encouragement of continued economic expansion and discouragement of the inflationary potential in such developments as the sharp fall in the dollar on exchange markets or continued large Federal fiscal deficits. In the process, ample liquidity has been provided to encourage economic expansion, though growth of economic activity has been very moderate since mid-1984. But monetary policy has also maintained a degree of restraint, as evidenced for much of the time by relatively high short-term interest rates in real terms (nominal rates less increases in the average level of prices), to help keep inflation and inflationary expectations under control.

The margin for error in monetary policy has become particularly small as U.S. budgetary and foreign trade deficits mounted. These deficits were widely seen as unsustainable and threatening inflation, recession, or both. Indeed, the course of the U.S. economy over the next year or two and the flexibility for monetary policy will be greatly influenced by how we manage to unwind the two massive deficits. Significant progress in reducing those deficits is vital to the long-run health of our financial and non-financial markets, but the process risks its own short-run instabilities. The issues are complicated, moreover, because U.S. markets for goods, services, and finance can no longer be considered in isolation, if they really ever could, and the smoothness and pattern of adjustment here will be influenced by events abroad and attitudes of foreign investors.

Budgetary deficits

The deficits in the budget of the Federal government over recent years for a time served a useful purpose. They were a major force propelling the U.S. economy out of the 1981-82 recession that had developed in the process of containing and reducing the inflation and inflationary psychology which had gathered steam during the decade of the 1970's. Recovery from the recession was more rapid than most expected at the time because of the large turnaround to fiscal stimulus and the virtually simultaneous let-up in the pressures of monetary restraint.

However, the increases in fiscal stimulus continued, though at a reduced pace, long after the economic recovery was in full swing and had turned into an expansion. The deficit has caused problems because it has been so large that it, together with the private capital formation we need to sustain economic growth at a satisfactory pace, could not be financed out of domestic saving, given the relatively low propensity to save in this country. As a result, we have had to tap foreign saving to finance our domestic needs for funds, with the large net inflow of saving from abroad serving to moderate in some degree upward interest rate pressures here from the deficiency of domestic saving.

For a while, until early 1985, the incentive to place funds in the U.S. was magnified by a strong rise in the dollar, caused in part by relatively high interest rates here. But as the dollar went up, it exerted pressure on U.S. manufacturers, who became less and less able to compete internationally, losing out in both export and domestic markets.

Another way of putting all this is that over the past four years, in part because of the sharp rise in net spending by the government, we, as a nation, have spent at a greater rate than we have produced. As a result, we have become dependent on net imports of foreign goods to meet our wants, financed by a net inflow of foreign saving. If that net inflow of foreign saving were to dry up, we would have to produce the goods ourselves. But it was becoming questionable whether we would have the financial and physical wherewithal readily to do so. Indeed, domestic spending on plant and equipment, after a strong rise early in the recovery period, fell off sharply as the economic expansion continued.

We now seem to be on the track of a less stimulative fiscal policy, which should result in lower actual budgetary deficits if our economy remains on a reasonable growth path and will in effect provide financial and real resources for other needed uses. Unless the budget measures seemingly in place come unstuck, a sharp swing away from fiscal stimulus appears likely for this calendar year, equal to on the order of 1 to 1½ percent of GNP according to OECD and IMF estimates made late last year. Some of this restraint may not be sustained, of course, as the budget process works out; and doubts about the potential for further restraint in later years are greater, given very difficult political and practical choices that have to be made. But the idea that fiscal policy may have turned away from its stimulative posture helped pull long-term interest down from earlier high levels, and I have little doubt that assurance of even more progress in store would help further.

The economic outlook and market developments over the year ahead will depend to a considerable extent on whether the apparent move from fiscal stimulus to fiscal restraint is sustained and how it is balanced against other economic forces. Fiscal restraint is needed to release the domestic financial and real resources required for improvement of our trade deficit and enhancement of domestic investment outlays. Without fiscal restraint, expansion in our international sectors, for instance, has an increased risk of intensifying inflationary pressures. But to realize the benefits of fiscal restraint also, and evidently, requires appropriate incentives for expansion of other sectors--in international sectors, for instance, a competitive exchange rate and expanding markets.

Trade deficit and exchange rates

The huge trade deficits that have emerged in the U.S. in recent years have, like the budget deficits, brought some short-run advantages but they have also entailed substantial long-run disadvantages. The main advantage of the trade deficit, and of the sharp rise in the dollar on foreign markets that peaked in early 1985 and which stimulated the deficit, was to facilitate

the policy of reducing inflation in the United States. The high dollar made imported goods relatively cheap, which meant that there was pressure on domestic producers to restrain their own price increases. And as our trade deficits became larger and larger both absolutely and in relation to GNP, there was less demand pressure on both labor and physical resources in this country, which contributed to the surprising rapidity with which wage increases fell back to a pace that was much less out of line with productivity gains than they had been.

But the negative aspects for the economy and markets of the burgeoning trade deficit were powerful. As income generated by, and sales prospects for, the international sector of the U.S. economy (export and import-competing industries) eroded, the very sustainability of the economic expansion was being threatened, not to mention our basic industrial base. The trade deficit, as has been apparent for some time now, needed to be corrected. In any event, it was unsustainable because the market was not going to tolerate an almost endless supply of dollars. A key element in the correction process has been the very sharp drop in the dollar on exchange markets since early 1985 that has worked to make U.S. industry more competitive internationally on a price basis. Our trade deficit in real terms is still not declining, but at least it seems to have stopped worsening, so that it is no longer a drag on growth. It should soon begin improving.

But it is not going to be easy for our economy to make a trouble-free transition to significantly lower trade deficits. There are both inflationary and recessionary dangers.

In the transition to a reduced reliance on net imports, more real resources must be brought into internationally competitive industries and, also, the spending of the domestic sectors of the U.S. economy must grow slower than growth in output. Bringing resources into the international sector has a clear potential for inflation. For one thing, it takes price increases on imported goods to make our import-competing industries competitive, and if these are reflected in a significant way in the general price level there is a risk of kicking off inflationary-type increases. That is most likely to happen in a relatively strong economy when international industries are bidding aggressively for labor and also plant resources to expand along with other sectors. I would not characterize the U.S. economy quite like that at this point. But even so, a sharp further drop in the dollar could well lead to inflationary price increases in this country before U.S. budget deficits contract enough to release the necessary resources. Indeed, the dollar drop we have already had has that potential if there is a backsliding on the budgetary front.

Looked at from the perspective of U.S. living standards, it is clear that if our trade deficit is to stop rising in real terms, and especially if it is to begin declining, growth in the spending of consumers, business, and government will have to be relatively modest. Spending of domestic sectors will have to rise less than our GNP in order to provide the margin of domestic resource availability needed as we shift toward exporting more

or importing less. Thus, over the next few years, we face a period in which real domestic spending should grow less than our real GNP. Over the past four years real domestic spending expanded on average by almost 1¼ percentage points per year more than our output. During the next few years, we will have to give up some of that.

Some of the give-up should occur more or less naturally if the personal saving rate moves back toward more normal levels, as I expect it will, which will retard consumer spending. Additional margins of resources should be provided as a consequence of restraints on governmental spending, and the more restraint we can achieve, the easier will be the adjustments that have to be made by other sectors. The worst way to reduce domestic demand would be through a recession. That has, of course, been the historical experience of many countries dealing with large current account and trade deficits. And that is most likely to happen the bigger the trade deficit gets in relation to a country's norm, the more delayed is the process of adjustment, and hence the more the need for a large quick adjustment to restore a diminishing confidence in the nation's currency.

In my judgment, the U.S. was close to the danger point where the possibility of an orderly adjustment of the economy as trade imbalances were being corrected was becoming rather remote. The drop in the dollar, the process of productivity improvements, and restraint on wage increases have come none too soon. But the likelihood of an orderly adjustment also depends on the momentum built into the economy at this stage, as reflected, for example, in the potential for inflationary pressures, the strength of private domestic spending, and the state of confidence. It depends as well on policies and developments abroad, since that will influence the exchange rate as well as demands for U.S. goods.

Momentum within the private economy

Assessment of existing inflationary conditions is crucial to the economic outlook, not to mention the stance of monetary policy, not only because reasonable price stability is a prime economic objective for the nation but also because inflation and inflationary expectations affect the real interest burden incurred in borrowing to finance outlays, given the nominal level of interest rates. The level of real rates in turn affects whether the economy is likely to generate upward momentum, to what degree, and under what conditions.

Clearly, we have made considerable progress in the U.S. in containing the inflationary pressure of the 1970's and very early 1980's. Average price increases have been running in the 3 to 4 percent range for four years now, a little lower last year helped by the break in energy prices. Perhaps more impressively, the fall-off in compensation increases in the U.S. has meant that labor costs in the nonfarm business sector have increased by only about 2½ percent for last year as a whole over the year before. Few experts seem to expect that remarkable performance to be repeated. But even with some little pick-up in labor costs, we do not seem to be in a position where inflationary pressures are likely to accelerate very much beyond the 3 to 4 percent range for the next year or so. Still, the potential upward effects

on prices should the dollar drop significantly further and uncertainties in commodity markets, such as oil, suggest the need for great caution in assessing the price outlook. And with regard to further progress toward price stability, whether or when we can get inflation below 3 percent per year on a sustained basis, and without an intervening recession, is a most difficult question.

If one were to assume, perhaps slightly optimistically in view of the exchange rate situation, that inflation is now running about 3 percent, then the real interest rate in the short-term market as of the moment is also around 3 percent. It would be higher in longer-term sectors for private debt instruments, even if the expected rate of inflation over the longer run were assumed to be 4 or perhaps 5 percent. Those real rates are much higher than in 1970's, when inflation accelerated. The short rate is not far from the 1960's levels, but the real long rate seems higher than at that time. Thus, I would think that present credit market conditions in and of themselves would not be much of a propulsive force for the economy. Whether they are about right, or potentially excessively restraining, depends in part on whether particular economic sectors do or do not have much thrust at this time from their own internal dynamics.

With regard to spending by individuals, I would expect that to be restrained over the coming year by some rise in the saving rate, as people become a little more conservative in face of the rapid build-up in debt of recent years. That doesn't mean consumption won't expand, but it does mean it would expand relatively less than income. It also means that it would take considerable acceleration in personal income to generate real strength in consumption.

In that regard, to generate growth in income, there is a high premium on improvements in profitability of, and access to markets for, our export and import-competing industries, particularly given the much desired turn to fiscal restraint in the Federal budget. I do believe notable progress has been made in making our international industries more competitive, so I would expect the international sector to contribute, and possibly fairly strong, to income generation. However, there are not many concrete signs of that yet. One cannot be at all certain whether the strong data on new business orders for durables coming in toward the end of last year reflects a positive change in business attitudes, contrary to indications in available surveys of plant and equipment spending. The increase in new orders could at least to some degree have reflected order accelerations related to the change in tax law.

Apart from a potential turn-around in our international accounts, there seem to be few sources of dynamism at the moment for business investment outlays. We are overbuilt in many nonresidential construction lines and, judging from the recent data flow, residential building does not appear to have much lift.

While some domestic economic sectors are certainly less than strong, and the extent of pick-up in the internationally sensitive areas is not

yet clear, elements of weakness in the economy should not be overemphasized. Employment growth has been surprisingly good in recent months. With the possible exception of autos, inventories are not out of line with sales, perhaps even on the skimpy side. And the wealth created since the turn of the year in the stock market could hold back the desire and need to save out of current income and thereby work to sustain consumption, as it often has in the past, as well as encourage business investment outlays. Of course, a sharp and sustained break in stock prices will do the opposite and possibly with more force. Finally, there is more than adequate liquidity in the economy to finance growing spending, given the substantial rise in the money supply over the past year.

Still, on balance, it is possible that spending propensities at the moment might not be strong enough to keep the economy growing at its potential on a continuing basis at the present level of real interest rates. In that case, a key question is whether real interest rates come down because prices accelerate, or because nominal rates decline, and how the economy might fare in the process. Before evaluating that, and the potential contribution of monetary policy in the context, it is useful to assess very briefly foreign policies and attitudes as they may interact with the U.S. economy and policies.

Economic policies and attitudes abroad

The major industrial countries abroad must deal with basic economic adjustments that in a sense are the necessary counterpart to adjustments here, and how they cope will also influence the U.S. economy. Some of those countries, chiefly Japan but also to a degree Germany, have relied on strong net exports to fuel their economies as domestic demand there was relatively weak in recent years. Demand was weak in part because many countries were, for long-run structural reasons, in process of reducing large governmental budgetary deficits that had evolved over a number of years. The earlier strength of the dollar, together with the relatively modest increases in labor costs abroad as compared with the U.S., facilitated reliance on net exports by foreign countries to stimulate economic expansion.

Following the sharp drop in the dollar over the past two years, the international competitive position of these countries has weakened considerably. They will in the future have to rely more on domestic demand expansion to keep their economies growing. They, and Japan is the exemplar, will need to shift resources away from international industries toward domestic uses--whereas the U.S. will be attempting the reverse. Just as in the U.S. a lower budget deficit is needed to provide resources to shift into the international sector and thus to reduce the odds on inflation, in other countries a more expansive fiscal policy is needed to help absorb resources being shifted out of the international sectors and thereby to reduce the odds on excessive unemployment.

So far, however, there is little evidence of any very substantial move toward fiscal stimulus abroad, although fiscal policy is probably easier

than it otherwise would have been in Japan. Without more fiscal activism, it seems doubtful to me that growth in key countries this year will be particularly robust. That will work to hold back, to a degree, improvements in the U.S. trade balance even as U.S. industry becomes price competitive. While strong growth in Japan and Germany would not by any means solve the U.S. balance of payments problem, it would relieve it at the margin over the near-term. It would also, by providing growing investment outlets in their own countries for savers, reduce the pressure to shift funds abroad and generate export surpluses in the process.

With fiscal policy in key countries abroad still likely to be relatively restrained over the near-term, monetary policy will have to be relied on more if foreign economies are to keep growing at a reasonably satisfactory pace. At this point, however, monetary policy is probably not a very powerful stimulant in some of these countries, such as Japan, given the high degree of liquidity already in the economy. Nonetheless, relatively low interest rates in Japan and Germany will help keep the exchange value of their currencies from rising further and of the dollar from falling. In that way it could provide an interlude in which these countries can set in motion domestic adjustments without heightening the risk of excessive unemployment that would be generated by an even further appreciation of their currencies and deterioration in export industries. At the same time, from the U.S. perspective, it would have the beneficial effect of moderating inflationary pressures here by easing the threat of further sharp reductions in the dollar.

Nonetheless, without more active measures to increase growth abroad fairly soon, or evidence of satisfactory improvement in the U.S. trade balance, there is still the risk that over time the markets will drive the dollar down much further because that will be perceived as the only available route by which the world-wide trade imbalances will be rectified within a reasonable time span. That would exacerbate inflationary expectations in this country, make it more difficult to attract foreign capital while the dollar is viewed as weakening, and make it much more difficult to sustain growth here while at the same time making further progress toward price stability.

Conclusions for monetary policy

For several years now, the U.S. economy and financial markets have moved forward but under a certain degree of restraint necessary to keep inflation subdued. That residual restraint has been evidenced by relatively high real short-term interest rates and an unemployment rate somewhat above what would appear to be "normal" for our economy at this point.

With the economic expansion in an advanced stage, and unless a new source of dynamism comes in--such as a sharp turn-around in our international sectors--the logic of economic events seems to point to lower real interest rates. That would have the not so incidental advantage of easing debt burdens. But much depends on how lower real rates emerge, and in that process monetary policy will necessarily take on a difficult and delicate role in the period ahead.

It is of course preferable for any decline in real interest rates to come from a drop in nominal rates rather than an acceleration in prices. However, a significant acceleration in prices cannot by any means be ruled out--one that, for example, brings price increases this year beyond the 3 to 4 percent range. Price increases could be stronger because the dollar falls much further on exchange markets, or commodity prices rise substantially, or because it turns out that an inflationary amount of money has already been created here. A decline in real interest rates because of rising prices and price expectations might be bullish for the economy and debtors in the short-run, but would be distinctly counter-productive for the longer-run health of the economy and would also necessitate countervailing monetary policy actions.

However, should inflation remain relatively low, and if the basic spending forces in the economy are not at the same time strong enough for the economy to grow consistently at its potential, a decline in nominal interest rates is likely to emerge in the market. Indeed, there are circumstances under which monetary policy might well take the risk this year of shifting the balance between accommodation and restraint more toward the easing side, becoming a little more willing to lead nominal rates down. Stability for the dollar on exchange markets would be a sine qua non. In that circumstance, and especially in the context of a restrictive federal budget policy, a tilt toward market ease rather than restraint is less likely to have the counter-productive effect of stimulating inflation expectations. But any such tilt this year, when there are doubts about the extent of inflationary potential, would also require clearer signs that real economic growth is in fact in process of faltering. Moreover, such a tilt should be buttressed by a little more reliance on the monetary aggregates, especially, I would say, M2 at this point, though still viewing that aggregate in the context of the whole group of money measures.

Indeed, under current circumstances, the aggregates might in any event be given a little more prominence in policy, most particularly if the economy does not soon show indications of economic weakness. The essential reason is because of uncertainty that market forces--as embodied in labor, goods, and world commodity markets--will in and of themselves be working to reduce inflation further and because of the non-negligible risk that inflation could go higher. In a period of sharply declining inflation and inflation expectations, the aggregates are not really an adequate guide to monetary policy, as we have seen in recent years, because of related very large, and basically unpredictable changes in interest rates and attitudes toward money. But when inflation stabilizes, or threatens to rise, the aggregates become a more useful guide, simply in the sense that they can then act like a governor on the fuel system.

If prices were to rise significantly, keeping the aggregates within bounds--assuming the upper limits of the Fed targets were not overly generous--would entail a renewal of upward pressures on interest rates, at least for a time. But I doubt such pressures would be long lasting under current conditions because, in view of the existing fragilities in

In fact, it has been my view in recent years, and still is, that we need lower and lower interest rates just to keep the economy in the same place, in part because real interest rates remain very high for most borrowers. Many economists measure real interest rates by adjusting interest rates for the Consumer Price Index, but as I like to joke, all of the Consumer Price Index in recent years is in college tuitions. I pay those for my daughter on a regular basis.

For most borrowers in this country, especially commodity producers, and manufacturing companies, real interest rates remain extraordinarily high. They have had little or no price increases, so for them, 8 or 9 percent interest rates represents a very high real interest and is prohibitive in many cases for investment decisions.

And, the LDC debt situation is still extremely serious. Higher interest rates would aggravate that.

In addition, we are embarked on a process of unwinding from large Federal deficits, which is absolutely essential for the long-term health of the economy. This in the short term will be restrictive, however, and tighter money will compound the restrictiveness.

Next, I think the basic money supply measure enormously distorts the growth in the money supply. It's being affected by a number of technical factors, such as deregulation and new financial innovation, and thus overstates the easing of monetary policy.

I think if you take all of these conditions into account, Mr. Chairman, in my judgment, it is inappropriate for the Federal Reserve to change their relatively accommodative monetary policy and, in fact, any change that would push up interest rates in the short term is not only inappropriate but, in my judgment, is extremely risky in view of the fragile nature of the economic situation.

I could have added to my list of reasons the fragile nature of many financial situations, especially in the view of the still serious LDC debt problem.

Now having said that, Mr. Chairman, I share your concern about the long term. The 8 or 9 percent growth in M2 and M3 of recent years is both tolerable and necessary. But I would agree with you that on a 5- or 10-year horizon that may be on the high side.

However, until we get Federal deficits down and reduce the pressure on credit markets from those deficits, and I think, as you know, we will need some tax increases to accomplish that, I think it will be very difficult to significantly reduce the growth in M2 and M3. But I do agree on a long-term horizon, that has to be implemented.

My view, though, is that it is premature, and for the time being, we have to tolerate a relatively accommodative monetary posture. Thank you.

[The complete prepared statement of Lawrence Chimerine, Ph.D, follows:]

CHASE

Chase Econometrics

Statement By

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United States Senate
Comittee on Banking, Housing and Urban Affairs
Washington, D.C.

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My name is Lawrence Chimerine, and I am the Chairman and Chief Economist of Chase Econometrics. I am delighted to have this opportunity to testify before the Senate Committee on Banking, Housing and Urban Affairs on monetary policy and the outlook for the U.S. economy. In addition, I would like to address some key economic concerns and their implications for longer-term economic performance.

SUMMARY

In sum, my views are as follows:

(1) Despite the fact that the current recovery is more than four years old, the recovery process has not been completed. The economy is far from being fully healthy and prosperous.

(2) Despite some uptick in several recent statistics, the long period of slow and erratic growth that has been in place since mid-1984 appears to be continuing. Thus, at this point, there is no conclusive evidence of either a major acceleration in the economy, or of a slide into recession.

(3) Slow growth is continuing because the stimulative impact of declines in oil prices, interest rates, and the U.S. dollar, and the boom in the stock market, are providing only modest stimulus. In addition, various negative factors are holding down economic activity.

(4) The underlying fundamentals suggest that this pattern of slow growth will continue during 1987 -- in particular, slower growth in consumer spending, weakness in capital spending, cutbacks in government expenditures, and very weak construction, will combine to hold economic growth to the 2% to 2.5% range despite some anticipated improvement in the trade deficit.

(5) The slow growth that is likely during 1987 implies that unemployment is likely to remain close to the near 7% level that has prevailed since early 1984. There will, however, be a modest acceleration in inflation to the near 4% range (CPI), reflecting rising import prices and higher oil prices -- as a result, real income will rise little, if at all, for most workers. Finally, I expect continued downward pressure on the U.S. dollar during the remainder of this year as a result of still high U.S. trade deficits, especially since economic growth in other parts of the world is likely to be very modest, which will limit the rebound in U.S. exports.

(6) The ability of the Federal Reserve to conduct monetary policy has been severely hampered by a number of conflicting factors, including still enormous budget deficits, the need to continue to attract funds from overseas, the fragile financial system, the potential for higher inflation, as well as still weak economic growth. Under these circumstances, the Fed has done an admirable job. However, it should be noted that the ability of monetary

policy to produce faster economic growth is limited by the high debt burdens which already exist, by widespread excess capacity and overbuilding, and by other factors -- thus, it is unlikely that monetary policy can produce significantly faster economic growth in the near term.

(7) The slow growth now underway may in fact continue for many years, in part reflecting the deterioration in U.S. competitiveness in world markets, and the enormous debt buildup in recent years.

(8) It is essential that budget deficits be reduced in an orderly way, and also that it be done in such a way as to not further jeopardize U.S. competitiveness. In particular, higher spending may be necessary for education, job training, etc. -- in order to finance these and still reduce budget deficits, some tax increases may be necessary, along with cutbacks in entitlement benefits to high-income individuals.

THE RECOVERY THUS FAR

The recovery which began near the end of 1982 is now more than four years old -- this makes this recovery period one of the longest on record. However, the health of the economy has nonetheless been overstated, as evidenced by the following:

(1) There have been two very distinctly different parts of the recovery period. The first eighteen months (or all of 1983 and the first half of 1984) was characterized by extremely rapid growth (over 7% at an annual rate as measured by real GNP). However, the two and one-half years since that time have witnessed a dramatic deceleration in the rate of growth to an extremely sluggish 2.5% average rate -- this is well below the historical average, so that only marginal additional progress has been made toward completing the recovery process. This is best illustrated by the fact that unemployment, capacity utilization and other measures of economic performance have shown no significant additional improvement since mid-1984. And, because of the dramatic slowdown since mid-1984, growth during this recovery in total is now below the rate experienced in most other postwar recovery periods -- and the average growth of slightly more than 2% since 1980 is far below that experienced in previous postwar decades.

(2) This period of extremely slow growth has taken place even though the level of economic conditions has not been satisfactory. This reflects the fact that the 1981-82 recession followed closely on the heels of a previous recession, so that economic conditions were extremely depressed when this recovery period began. Therefore, virtually all measures of economic performance are still unsatisfactory. For example, the near 7% unemployment rate that has prevailed during the last two years is obviously a significant improvement over the near 11% rate of late 1982, but it is still much higher than at anytime in the postwar period prior to the 1980s with the exception of the 1974-75 recession.

(3) The performance of the economy during the past several years

has been highly uneven, with many sectors still mired in recessionary conditions. This has created major industry and geographic differences which are causing severe hardships in many areas.

In sum, the performance of the economy in recent years, at least with respect to real economic growth, has been vastly overstated -- the recovery in total has not been particularly strong and is far from complete; we have experienced only marginal additional progress in completing the recovery process during the past two and one-half years; and the economy is still operating at highly unsatisfactory levels by historical standards.

THE CURRENT ECONOMIC SITUATION

Despite some uptick in recent statistics, the economy is still growing at a relatively slow pace, in my judgment. The uptick in some of these recent data exaggerate strength in the economy:

1. Unemployment has dropped slightly in recent months, in part because of a relatively large increase in new jobs, especially in January. However, it appears that this improvement has been exaggerated somewhat by unreliable seasonal adjustment factors, particularly with respect to construction and retail trade jobs. In particular, the increase of nearly 450,000 payroll jobs in January included a rise of 140,000 in construction, with the remainder in retail stores, fast food chains, health care, and other services. However, new construction contracts have been trending down for more than a year, so that the increase in construction jobs in January will be reversed in the months ahead. Furthermore, a relatively large share of the new jobs in services in January were part time, and were at wages well below the national average -- thus, income growth was very modest despite the large increase in new jobs. And, many companies have announced layoffs which will be effective at various points during 1987 -- most of these have not yet shown up in the employment statistics. Finally, the still sluggish level of help-wanted advertising also indicates that labor markets are still not very strong.

2. The very strong 4.4% rise in retail sales in December severely distorts the underlying pattern of consumer spending: (a) The rise was heavily concentrated in purchases of new automobiles, prior to the elimination of sales tax deductibility on January 1. Nonauto spending rose a more modest 0.9%; and some pre- tax-reform purchases of furniture, appliances and other consumer durables may have artificially boosted sales of those goods. (b) Sales were revised sharply downward for November -- thus, excluding the zigzag pattern of auto sales, spending was almost flat for the two months combined, and have grown much more slowly since mid-summer than during 1985 and the first half of 1986. (c) Early indications suggest a significant tailing off of retail activity in January -- not only were auto sales very soft because of the high level of "borrowed sales" in December, but many retail chains reported sluggish activity as well, especially for household durables.

3. While industrial production will continue to grow, after the almost stagnant pattern of the past two and one-half years, the rate of increase will decline significantly from the November-December performance: (a) Auto production rose significantly in December -- not only will such an increase not be repeated, but significant cutbacks are likely in the months ahead. (b) Defense and space output has risen at more than an 8% annual rate since mid-summer -- recent cutbacks in appropriations for military procurement will begin to slow the growth in military output in the months ahead. (c) Utility output, while erratic on a monthly basis, has risen at a relatively strong but unsustainable pace on average in recent months. (d) It is likely that production of some business equipment and consumer durables were higher in the last two months than would have been the case because of the pre-tax-reform related activity -- this should be reversed during the next several months.

4. The sharp rise in both housing starts and permits in December has raised hopes that recent declines in mortgage rates are beginning to spur a new surge in housing activity; however: (a) The December rise comes from a relatively low (and downward revised) level in November and earlier months. (b) More than half of the rise was in multifamily structures, which is almost certain to be reversed in coming months in view of the still enormously high (and rising) vacancy rates in most areas, and the adverse effects of the new tax structure. (c) The overall figures were heavily influenced by a surge in activity in California as builders tried to avoid higher building fees which became effective in January. (d) Starts were also bolstered by relatively mild weather in most of the country in December -- January weather was less favorable.

5. While the trade deficit did drop sharply in December, it is premature to conclude that a significant turn has developed. This in part reflects the fact that imports surged in November prior to the imposition of a new customs fee and prior to tax reform -- some of this was probably borrowed from December. Thus, the average level of imports and the average trade deficit in the fourth quarter was only slightly below the third quarter. Imports from some of the countries against which the dollar has not declined were even down significantly in December -- this likely reflects either erratic movements in the data, or the special factors cited above, since it is unlikely that imports originating in those countries are falling because of currency movements.

6. Fourth-quarter GNP rose at a disappointing 1.7% rate (preliminary estimate) -- even adjusting for a relatively small rise in defense spending and some payback in auto sales from the incentive-spurred third-quarter, growth in the fourth quarter was below the average for the last two and one-half years. Capital spending was especially weak in the fourth quarter, despite efforts to beat the change in the tax laws.

7. New Orders for Durable Goods continues to see-saw -- excluding defense, they have trended only slightly upward in recent months. Furthermore, much of the recent rise was probably tax reform

related -- in addition, orders for commercial aircraft have been very strong, but because of the long production cycle, these will contribute very little to near-term economic activity. And orders for household durables have flattened out.

8. The large increase in the leading indicators for December also overstates economic strength because at least one-half of the rise was due to some of the temporary factors which affected other statistics -- furthermore, the relationship between the index and economic growth has been very poor in recent years.

On balance, therefore, when erratic movements in the data, revisions to earlier data, and the effects of tax reform are taken into account, it is still premature to conclude that the overall economy is accelerating -- this is confirmed by feedback from Chase Econometrics clients, and from more recent economic data.

WHY HAS THE ECONOMY BEEN SO SLUGGISH?

The sluggishness has continued despite numerous forecasts that a major acceleration would take place during 1986 because of declines in interest rates, the dollar, and oil prices, and other apparently favorable factors. However, the economy has not picked up, for the following reasons:

(1) The sharp decline in interest rates that has occurred since late 1984 has had only a small stimulative effect on the economy thus far, since real interest rates were extraordinarily high when these declines began. Thus, in effect, rate declines were necessary just to keep the economy in the same place, and in great part have been caused by the weak economy. The only noticeable effect of the decline in rates has been on the housing industry -- real interest rates for industrial companies are still so high that there has been virtually no impact of recent declines in nominal rates on capital spending plans or on inventory policies. The impact of declining interest rates is also being limited by the age of the recovery, the winding down of previously available pent-up demands, low utilization rates, overbuilding, and already high debt burdens, which have reduced the willingness of both corporations and households to incur additional debt. Thus, the Fed is in great part pushing on a string.

(2) The economy has not yet experienced any significant benefits from the sharp decline in the value of the dollar, primarily because the large trade deficit reflects major deterioration of the United States competitive advantages that has occurred over many years (this will be discussed further below) -- thus, modest declines in the dollar will not solve the problem.

(3) The stimulative impact of lower oil prices on the economy has been modest, at best. In great part, this reflects the fact that the United States is a large producer of oil (we produce about 70% of our own needs), so that the main benefit of declining oil prices has come from a decline in the price of imported oil. However, oil imports relative to GNP have fallen sharply since the early 1970s

(by more than 50%), reflecting that fact that we consume far less energy relative to the size of the economy than we did then, that oil now constitutes a smaller fraction of our total energy consumption than at that time, and that we produce a larger fraction of our internal needs ourselves. The negative effects of lower domestic oil prices on profits in the oil industry caused sharp cutbacks in employment, and in exploration and other investment. These represented very sizable offsets to the gains to consumers, and profits to oil users, that resulted from lower domestic oil prices. Furthermore, because of already large current account deficits, most OPEC countries are reducing their imports of military and manufactured goods from the United States and other countries, which is offsetting part of the favorable effects of the lower cost of imported oil.

(4) In my view, the stock market boom does not reflect either current or expected economic strength -- in fact, the rise in stock prices is more accurately a sign of weakness, since it largely reflects the sharp decline in interest rates, which in turn is a direct result of the sluggish economy. In effect, the substantial increase in liquidity that has been pumped into the economy by the Federal Reserve has gone primarily into financial assets rather than fixed assets, reflecting the lack of viable fixed investment opportunities due in part to overcapacity, overbuilding, etc. Thus, many companies have found it more attractive to buy up their own stock, or someone else's, rather than making investments in plant and equipment. Furthermore, the sharp increase in the value of financial assets held by consumers is also vastly overrated as an economic stimulant, since: (a) ownership of financial assets is concentrated among relatively high income families with a relatively low marginal propensity to consume, (b) most individuals cannot gain access to these funds because they are tied up in pension accounts, and (c) many of those who have experienced capital gains have rolled them over rather than using them to finance consumption. In addition, household debt has risen dramatically during this period, with a far more widespread distribution across the population.

(5) Many forecasters had predicted an inventory-led acceleration in economic growth in 1986, reflecting the relatively low inventory/sales ratios which prevailed at the end of 1985. However, inventory/sales ratios have not been low because goods have been jumping off the shelves -- they have been deliberately reduced by manufacturers and retailers because of: (a) extremely high real interest rates; (b) large excess capacity; (c) relatively short lead times; (d) the still weak prices of many finished goods and commodities, and the uncertain price outlook; (e) the uncertain sales outlook; and (f) weakness in profits. The downsizing of desired inventory levels is in fact continuing, so that inventories are still a neutral factor at best in the economic situation.

(6) Some forecasters also predicted a surge in the economy as a result of sharp increases in the basic money supply during the last eighteen months. However, there is currently almost no relationship between M1 and economic activity, reflecting: (a)

continued increases in import penetration, which increases the demand for credit and the money supply without increasing domestic output; (b) declining interest rates, which have reduced the opportunity costs of holding interest free or low interest deposits; (c) concerns regarding the safety of deposits at various thrifts and other financial institutions, which has caused a shift of savings into M1 types of deposits; and (d) financial innovation and deregulation, which have created new instruments.

THE OUTLOOK FOR 1987

I believe that the outlook is for continued subdued growth during 1987, with a likely rise in real GNP of 2.5% at best. This expectation is based not only on my assessment of the recent data, but also on the underlying fundamentals.

(A) As indicated earlier, consumer spending has already begun to grow more slowly once the effects of auto incentive programs, tax reform, etc. are smoothed out. This trend will continue through 1987, and possibly beyond, for the following reasons: (a) There is every indication that real wages will remain stagnant, reflecting continued cautious wage policies and an acceleration in inflation. While slow wage growth is still most pronounced in manufacturing (fully one-third of all recent union contracts have actually included wage rollbacks), it is now spreading to other sectors as well (two-tiered wage systems and the increased use of lower wage subcontractors are further holding down average wages). The acceleration in inflation is coming primarily from external sources (rather than from internal income shifts), especially from the recent increases in oil prices and sharp declines in the U.S. dollar. Thus, even factoring in the personal tax cuts which will result from tax reform this year, real income per worker will grow little, if at all. And, with slower growth in new jobs, and the high concentration of those jobs in lower-than-average wage occupations and industries, total real disposable income will grow at only about 1.5% during 1987. (b) It is increasingly clear that consumers will be unable to continue to finance a relatively large fraction of new spending by going deeper in debt. This in part reflects the increased difficulty that many households are having in servicing existing debt, the gradual tightening in lending standards by many financial institutions, the already near-record low saving rate, and the erosion in consumer confidence in recent months. (c) Slow income growth, rising debt burdens, and lower saving rates are coming at a time when available pent-up demand, especially for various consumer durables, has fallen -- this will compound their effect.

(B) The capital spending outlook remains poor. Low operating rates, the new (less favorable) tax structure, and already high corporate debt are all holding back new business investment -- the only positive might be an improvement in profit margins for those companies which will have more leeway to raise prices as prices of competing imported goods rise in response to the weaker dollar. However, capital spending will lag any improvements in profits, so that any gains will not occur until very late in 1987 at the

earliest. Inventory policies will also remain cautious.

(C) Despite lower interest rates, virtually all categories of public and private construction are likely to be weaker this year than last. Even new housing activity will be down by more than 5% -- in fact, total housing starts rose only slightly last year, despite the sharp decline in mortgage rates, indicating that slow income growth, depressed economic conditions in some regions, a reduced number of first time buyers, overbuilding, etc. are already beginning to hold down new housing construction.

(D) While the sharp drop in the dollar in recent weeks probably reflects several factors, including increasing concerns about the health of the U.S. economy, the growing likelihood of U.S. trade legislation, the rise in oil prices, the increasingly deadlocked U.S. political situation, and the possible departure of Fed Chairman Volcker, I believe the major factor is the increasing recognition that the competitive problems which exist in the United States are more serious than earlier assumed (as will be discussed later). Nonetheless, a modest improvement in the trade deficit will occur during 1987, for the following reasons: (a) The strengthening yen has already caused a significant decline in Japanese exports -- signs of softening German exports are also beginning to develop. Much of these exports would have flowed into U.S. markets. Moreover, increases in prices of imported goods produced in those countries have begun to accelerate and spread --considerably more are likely in the months ahead. (b) It appears that inventories of imported goods (especially automobiles) have increased recently, which will reduce new orders in the months ahead. (c) The appreciation of the yen and the mark will enable the United States to attain a higher share of worldwide exports to the Far East NIC's and the lesser developed countries. (d) Oil imports will grow more slowly in 1987, now that inventories of crude and refined products have been built up.

It should be noted, however, that the effects of declines in the dollar and the trade deficit on near-term economic growth will be modest:

1. The drop in the trade deficit will be fairly modest, because: (a) The dollar has not changed significantly against most currencies other than the German Mark and the Japanese yen -- any improvement in our bilateral trade deficit with these countries will be offset at least in part by rising imports from other countries. (b) The impact of dollar declines will also be limited by the fact that many imported goods have no domestically produced counterparts, by the perception that some have higher quality than comparable domestically produced products, and by the increased familiarity of American citizens with foreign produced goods. (c) Domestic demand remains soft in the industrialized world, and very weak in Mexico, most OPEC countries, and Africa -- this will limit any improvement in U.S. exports. In essence, worldwide economic growth is being limited by very restrictive fiscal policies in most countries, by somewhat restrictive monetary policies in many countries, by worldwide overcapacity, by weakening investment

(particularly in those countries whose currencies have appreciated, because of the squeeze on profits being caused by their stronger currencies), and by widespread cost cutting. This will not only limit any turnaround in trade in the near term, but suggests that significant additional declines in the U.S. dollar will be needed to produce major improvements in the trade deficit in the years ahead.

2. The increase in import prices, by adding to inflation and squeezing purchasing power (especially since imports now account for a much larger share of consumption than in the past), will reduce spending for some domestically produced goods as well (the income effect of the dollar decline).

3. The recent sharp drop in the dollar will probably delay any additional cuts in the discount rate. Furthermore, it is unlikely that long-term interest rates will decline significantly from current levels, barring a far weaker economy than now expected. This reflects not only the added inflation resulting from dollar declines, but also that the apparent willingness of key U.S. policy makers to see an even lower dollar may cause foreigners to cut their purchases of Treasury and other securities until the currency risk is reduced. Thus, the continued slow growth we envision will not likely be accompanied by continued declines in long-term interest rates as in recent years -- this will act as an additional constraint on growth, because even lower rates are needed to bolster demand at this stage of the economic cycle.

These forces suggest that domestic demand will grow very slowly during 1987 (1.5% - 2%), in contrast with the sharp rate of increase during the past several years. Thus, barring a monumental turn in trade, it is extremely unlikely that the economy will break out of its relatively slow growth pattern --more likely, a modest improvement in trade will be counterbalanced by the significant deceleration in final domestic demand already underway. And, while industrial output may do somewhat better in 1987 than in 1986 because of the absence of additional sharp cutbacks in oil and gas activity, as well as because of the smaller trade deficit (in real terms), this will be offset by slower growth in services as well as by declines in construction. The recent boom in the stock market will not significantly alter this pattern, primarily because the incremental spending that is likely from the increase in household net worth is very small in view of the heavy concentration of ownership of common stocks among high-income individuals, and because of the high debt/low saving environment which already exists. Furthermore, as noted earlier, the market appears to be being fueled mostly by the vast amount of liquidity that has been pumped into the economy by the Federal Reserve, and the channeling of a large amount of that liquidity into stocks rather than capital goods, commodities, real estate, etc. Finally, potentially higher profit margins due to the weaker dollar are also bolstering the stock market.

I continue to believe that there are sizable downward risks in the near-term outlook, so that a recession sometime during 1987 or

early 1988 cannot be ruled out. These include the following: (a) Plant closings and production cutbacks in the auto industry may be even greater than now expected -- moreover, the loss of income and consumer confidence caused by these layoffs could cause weaker consumer spending. (b) It is possible that the turn in the trade deficit could begin somewhat later, and/or could be somewhat slower, than now expected. (c) The change in the tax structure on January 1 may have more adverse transitional effects than now expected.

With respect to inflation, a modest acceleration, at least as measured by the CPI, is almost certain in 1987. This will primarily reflect the modest increases in oil prices in recent months (which contrasts sharply with the declines in energy prices during much of 1986), and the fact that the weakness in the dollar will cause more widespread and sharper increases in the prices of imported goods. In addition, this will provide some leeway for domestic manufacturers to raise prices, especially if they are more interested in rebuilding profit margins than increasing market share relative to foreign competitors. I estimate that the Consumer Price Index will rise by about 4% during the course of 1987, following the 1.1% increase during 1986. It should be noted that other measures of inflation, especially the GNP price deflator and the Producer Price Index, will show considerably smaller increases because they are not directly affected by import prices as is the CPI.

The continuation of modest economic growth that I expect during 1987 will preclude any sizable declines in unemployment -- thus, it is likely that the national unemployment rate will remain very close to the current rate of slightly below 7%. I do expect some increase in manufacturing jobs after declines in recent years -- this will be counterbalanced by smaller increases in the service sector and by declines in construction jobs.

MONETARY POLICY

The conduct of monetary policy has been complicated enormously by a number of conflicting considerations:

1. The misguided fiscal policies of recent years, which have produced enormous budget deficits, have put additional pressure on the Federal Reserve to increase the supply of money, despite the possible long-term inflationary consequences. Furthermore, the Fed's policy decisions are now being complicated by the need to reduce deficits -- the restrictive impact of deficit reduction in the short term argues for even easier monetary policy, despite the long-term risks.

2. In order to finance these large federal deficits and the growing private demand for credit, it is necessary that we attract a large inflow of capital from overseas. Thus, any changes in monetary policy that could cause a free-fall in the dollar could be counterproductive for the U.S. economy by discouraging foreign investment in the United States, thus pushing up interest rates.

3. Long-term interest rates are still relatively high for most borrowers, in part because of still widespread concerns about future inflation in view of the large budget and trade deficits. However, an excessively easy monetary policy could heighten these concerns, and actually cause even higher long-term interest rates.

4. The Fed's policy decisions must take into account the fragile nature of the economy, as well as of the financial system. Thus, any tightening designed to maintain an inflow of credit and/or to reduce inflationary expectations, could actually weaken the economy in the short term and potentially lead to a significant downward spiral. In effect, the impact of monetary policy changes in the short run is now asymmetrical -- higher rates would weaken the economy considerably, but lower rates will have only limited stimulative effects.

5. Because of the sharp rise in interest payments relative to total federal spending in recent years, higher interest rates would raise the federal deficit significantly, even without any indirect effects.

Under these conditions, I give the Federal Reserve high marks for its conduct of monetary policy in recent years, particularly since it has remained relatively accommodative despite the rapid growth in the basic money supply. It is important that a relatively accommodative monetary policy be continued for the following reasons: (a) The relatively strong growth in M1 in recent years should not be cause for alarm. This reflects the fact that the relationship between money growth and economic activity, which has never been very precise, has been distorted even further by the surge in import penetration in the United States. In effect, the money and credit needed to purchase imported goods are essentially the same as that needed to purchase domestic goods, so that the growth in GNP will lag behind money growth when imports are rising rapidly. Furthermore, financial market deregulation in recent years has made M1 a less reliable measure of spendable cash. The growth in other monetary aggregates have been much more moderate -- these are probably more meaningful guides to the availability of money and credit in the current environment. (b) Despite the decline in nominal rates, real rates still remain relatively high. It appears that lower rates will be necessary to maintain current economic growth rates. (c) The LDC debt crisis would be aggravated by higher interest rates and slower economic growth -- this could jeopardize the entire financial system.

Perhaps the biggest concern is that, while a highly accommodative monetary posture is warranted now, it cannot be sustained on a long-term basis. However, large and growing Federal budget deficits, the net debtor status of the United States, and the international debt situation, are pushing the Fed into a corner by narrowing its option to become less accommodative if other factors so warrant. In my judgment, significant budget deficit reduction would help overcome this problem by directly exerting significant downward pressure on interest rates -- under those conditions, interest rates can be considerably lower, and the world economic

The CHAIRMAN. Thank you very much, Mr. Chimerine.
Mr. Heinemann.

STATEMENT OF H. ERICH HEINEMANN, CHIEF ECONOMIST, MOSELEY SECURITIES CORP.

Mr. HEINEMANN. Thank you, Mr. Chairman.

I take a somewhat different view of the current economy than my friend, Mr. Chimerine. It seems to me that we have had a solid expansion in domestic demand now throughout this business cycle from 1982. From the end of 1982 up through the most recent quarter, growth in real domestic final sales was 4.8 percent, way above the post-war average.

In the last 2½ years, which Mr. Chimerine made reference to, the growth has been 3.9 percent—slower, but still above the average.

In the last 5 or 6 months, we have seen a sustained and quite remarkable reacceleration in growth in payroll employment. Consumer attitudes, as measured by the Michigan survey, continue to be quite good.

We have seen growth in the leading indicators accelerate close to a 10-percent annual rate in the last 6 months or so—7 months—compared to a growth rate of only 6 percent in the year ended June 1986.

So I think we've got a lot of domestic momentum in the economy at the present time. There is forward motion, and the trade deficit, which has been the principal factor inhibiting expansion I think is now clearly starting to turn around.

Now in this context of solid, if unspectacular, domestic expansion and the probability of some significant improvement in our international sector, we have seen a very remarkable monetary acceleration which you made reference to, Mr. Chairman, in your opening statement.

GROWTH IN HIGH-POWERED MONEY

Over the past 2 years—actually over the past 4 years, we have seen a systematic and progressive acceleration in the growth of what I call high-powered money—the reserve aggregates most closely related to the size of the Federal Reserve System balance sheet. We have seen a progressive acceleration in the monetization of the Federal debt.

Total bank reserves, according to Fed data released last Thursday night, averaged $56.7 billion in January. That was almost 25 percent higher than the same month a year earlier. This is not an isolated phenomenon. This progressive acceleration has been going on for a long time.

The average growth in bank reserves over the last quarter of a century is somewhat less than 5 percent. So we are running close to five times the characteristic behavior of reserve expansion over the last quarter century.

It seems to me that over time ripple effects from this rapid expansion of liquidity will inevitably spread throughout the economy. We already see debt rising much faster than GNP and I think that process will continue.

Prices of imported products, other than oil, are rising at a rate of about 8.5 percent at the present time. With the recent weakness in the dollar I would expect that rate of increase to accelerate. Since imported products represent about 28 or 29 percent of the goods sector of the American economy, that increase in prices of imported products at the wholesale level will increasingly suffuse through our domestic price structure, in my judgment.

I think the risk of general reflation is rising. I think our foreign creditors, who are quite sensitive to this inflationary potential, have become and will increasingly become reluctant to lend us the roughly $3 billion per week that we must borrow in order to finance our imports.

They will in fact lend us what we need, but they will not lend us those sums at prices we can afford to pay.

I think we will see, absent some tightening of monetary policy, further declines in the dollar. I can see significant increases in interest rates and I can see the threat of a recession fairly close in the future.

In my judgment, Mr. Chairman, monetary growth has already reached such an extreme level that correcting the excess will inevitably involve a significant real economic cost. As usual, those least able to bear it will have to carry much of the burden.

However, further delay in bringing monetary growth under control, in my judgment, would only increase those costs. I believe very strongly the issue confronting Congress, the administration, the Federal Reserve, and the financial markets is not whether interest rates will rise, but when and by how much.

No one wants a recession and we all recognize the structural problems that Mr. Chimerine made reference to. However, notwithstanding the short-run costs, I think the Federal Reserve should take four actions.

First, take immediate steps to reduce the rate of monetary growth in the high-powered reserve aggregates most closely related to the size of the Federal Reserve System balance sheet to levels consistent with the Fed's own stated but generally ignored guidelines for non-inflationary monetary growth.

Second, I think we have to reverse the drift in Federal Reserve policy back toward interest rate targeting. We gave it up in the late 1970's on clear evidence from the Fed that using interest rates for monetary policy targets had played an important role in contributing to the inflation of the 1970's. But we have drifted back there.

Third, I think we should establish a single target for growth in the monetary base. The base is in effect a proxy for the Federal Reserve System balance sheet. It is similar to the target which the Bundesbank, the German central bank, establishes for what they call "central bank money." We should adhere to that target over some reasonable period of time.

I think it is a mistake to publish multiple policy targets and then decide ex post to focus on whichever one happens to be performing in line with preconceived ideas about the level of interest rate. I think it is wrong to establish targets and then regularly ignore them. If targets are not going to be followed, they should not be published.

Finally, the Fed should spell out clearly for the American public what the implications of a policy of easy money and competitive devaluation really are. Any elementary economics textbook will tell you that this policy is designed to produce a faster rate of domestic inflation and a reduction in the relative real wage in the country doing the devaluing, namely, the United States.

I think we have to make plain that if inflation does not speed up and relative real wages do not decline, then we will not get the improvement in the trade balance which we all expect.

I think we have to be clear that if the external value of the dollar declines, its internal value will drop as well. That is something that investors need to be very clear about.

VELOCITY

I do not see any empirical evidence of any permanent, long-run change in the behavior of velocity. Velocity is always very volatile. The ratio of GNP to money supply is most effectively described by the term "white noise" in the very short run.

However, I see no systematic, sustained evidence that there has been a permanent change in the long-run behavior of velocity. It seems to me that the Federal Reserve in layman's terms is printing money on the theory—or perhaps it's the hope or the prayer—that no one will ever spend it. And I think that is a simplistic and dangerous assumption.

My colleague on the Shadow Open Market Committee, Robert Rasche, has done extensive research on the behavior of velocity. I would commend his work to you. I don't know whether it's actually in final published form yet, but I would commend his work to you. His conclusion: there has been no permanent change in velocity.

We have had repeated warnings in the foreign exchange markets that declining real rates in the United States suggest a diminished incentive for foreign investors to hold dollar balances at today's price. We have seen a sharply declining dollar partially offset by rising levels of central bank intervention to slow that drop.

The consensus forecast in Wall Street and here also in Washington suggests that the U.S. current account—a $150 billion deficit which won't change very much in nominal terms this year—can be financed readily and without disturbance if real interest rates roughly decline by half this year.

The Congressional Budget Office, for example, suggests that real interest rates, using the bill rate less the current inflation rate, will be about 2.1 percent this year compared to 4.4 percent last year.

I think we have clear evidence in the exchange markets that that kind of an outlook will not be acceptable to foreign investors from whom, as I noted earlier, we must borrow approximately $3 billion per week in order to finance our imports.

The record of monetary policy, Mr. Chairman, has been one of great volatility in recent years. In my prepared statement I put together a little table reporting the year-on-year change in money supply since 1979, picking the extremes in the curves, the tops and bottoms. In the third quarter of 1979, money growth was about 8.3 percent; second quarter of 1980, 4.3 percent; second quarter of 1981,

9.9 percent; fourth quarter of 1981, 5 percent; third quarter 1983, 13 percent; fourth quarter of 1984, 5.4 percent; and, if current trends continue, in the first quarter this year, the growth year-on-year will be about 17.3 percent.

It seems to me with this kind of a volatile record, it's very hard to assess the impact of monetary policy on the economy. It's hard to see that a strategy of monetary policy that relies on progressively larger oscillations in monetary growth will lead to stable macroeconomic performance.

I am particularly disturbed, Mr. Chairman, that since last September short-term interest rates have shown a modest upward bias in the face of an average month-to-month change in total bank reserves something over 30 percent. Now something is wrong if interest rates go up in the face of that kind of an injection of liquidity into the banking system.

This is not—and I repeat—not a short-term phenomenon. The sustained decline in interest rates since 1984 has been systemmatically associated with accelerated rates of expansion in all of the relevant monetary measures. When and at what level of growth in high-powered money will this process come to an end? 50 percent? 500 percent? I don't know, and we don't have much guidance from the Federal Reserve.

The Fed's rhetoric against inflation is vigorous. But its actions go in the opposite direction.

[The complete prepared statement of H. Erich Heinemann follows:]

situation considerably healthier, even with a more neutral monetary policy. Until that happens, I would encourage the Fed to avoid any actions which would push up interest rates in view of the fragile economic situation -- in fact, some additional easing may be warranted if the economic statistics weaken in the next few months.

LONG-TERM OUTLOOK

Trade Deficits and Long-Term Growth

It is generally expected that the U.S. trade deficit will decline during the years ahead, that these declines will add between 0.5% and 1% per year to average economic growth (reversing the pattern during the last several years), and that this reversal will permit overall growth to approach its near 3.5% long-term average. As discussed earlier, I share the expectation that the trade deficit will soon begin to decline, and that this trend will continue over the long-term -- in fact, such an outcome is almost essential because U.S. foreign debt would otherwise reach levels that would be both unsustainable and potentially highly destabilizing. However, a decline in the trade deficit does not necessarily imply that economic growth will accelerate -- it implies only that output growth will exceed domestic spending.

I, in fact, believe that economic growth in the United States will lag behind the postwar average for many years, despite a falling trade deficit. One reason for this expectation is that a major factor which produced the staggering U.S. trade deficits has been a narrowing during recent years (or elimination in some cases) of the competitive advantages that the United States enjoyed after World War II. These advantages resulted from the development and implementation of new technology, the use of more sophisticated mass production techniques in manufacturing, the mechanization of agriculture, etc. -- they caused average productivity in the United States to far exceed that of other countries (and the gap to widen) for many years.

The "catching up" of the rest of the world during the last 15 years appears to reflect a number of factors, including the spreading of technology throughout the world, the rebuilding of war-ravaged infrastructures in Japan and much of Europe, and investments in new and modern facilities in many other countries. However, the earlier U.S. productivity advantages were used to raise wages and income levels substantially throughout much of the economy -- these increases in wages have now produced an enormous disparity in labor costs, which, when combined with differences in capital costs, can no longer be justified by productivity differentials. This deterioration in relative U.S. competitiveness is evidenced by the rise in the U.S. bilateral trade deficit with Japan and some other countries during the late 1970s and early 1980s -- several temporary factors, including surges in bank-financed exports to Latin America and oil-financed exports to the Middle East, as well as an undervalued U.S. dollar (especially in relation to European currencies), temporarily bolstered our aggregate trade performance at that time despite the deteriorating fundamentals. When these temporary factors were reversed, the U.S. trade balance began to worsen rapidly -- enormous budget deficits and the overvaluation of

the dollar in recent years accelerated this trend.

While efforts have been made to improve productivity and lower costs in the United States in the last several years, it seems clear they have not been enough to improve U.S. competitiveness sufficiently to bring about a sharp decline in future trade deficits. First, while productivity growth has accelerated in manufacturing, aggregate productivity growth still remains disappointingly low. And, much of the improvement in productivity in industry reflects layoffs, rather than benefits from the increased use of new technology or more efficiency in the manufacturing process -- this process can't be repeated indefinitely, especially since many of the employment reductions have been among managerial and nonproduction workers. Many U.S. industries thus are now experiencing the worst of both worlds --falling employment and continued erosion in market share. Second, while many companies have frozen or even cut wage rates (in addition to staff reductions), wage levels remain far above those in many other countries (especially the Far East NIC's). Third, efforts to improve efficiency and reduce costs are being implemented in Japan and other countries, offsetting some of those being made in the United States. Finally, the decline in the dollar thus far has had only a modest affect on U.S. competitiveness because it has been limited to the Japanese yen and the major industrialized countries in Europe.

In view of these factors, and of the continuing sluggish conditions in many other parts of the world (which will hold down U.S. exports), I thus believe that a combination of additional dollar declines (some are now happening) and slower growth in domestic demand will be necessary to bring trade deficits down even modestly in the future:

(1) Underlying productivity trends suggest that the trade-weighted average of the dollar in real terms may have to fall to, or below, the early 1980s levels in order to produce the same degree of relative competitiveness which existed at that time. This trend implies a continued upcreep in inflation as dollar declines are increasingly reflected in higher prices for imported goods, and as prices of domestically-produced competing goods are raised in response.

(2) Barring even sharper declines in the dollar, a long period of relatively slow growth in domestic demand will also be necessary to bring the U.S. trade deficit down -- each 1% decline in the growth of domestic demand in the United States will reduce the growth in real imports by approximately 2%, thereby cutting the trade deficit by about $8 billion per year (on a cumulative basis). I especially believe that growth in consumer spending will be sluggish for many years, reflecting the effects of cutbacks in white and blue collar employment and wages, and declines in the value of the dollar, on household purchasing power (real wages already are stagnating, as discussed earlier). This conclusion is reinforced by data indicating that wages and salaries among the job losers in recent years have been above the average in most cases, and that wages for

a large fraction of the new jobs that have been created have been below the average. While the increase in prices caused by dollar weakness will help bolster profits, I do not expect this to translate into larger wage increases or employment gains for at least several years in view of the desire of many the desire of many companies to rebuild profit margins.

Implications of the Debt Buildup

An enormous and unprecedented buildup of debt has occurred in the United States during the last five years -- during this period, total nonfinancial debt has increased at a rate more than twice as fast as nominal GNP, pushing the total debt-to-GNP ratio up sharply after more than 30 years of stability. The rise in debt has even far outstripped the growth in domestic demand, so that the adverse effect of the growing trade imbalance on real output explains only a small portion of the rise in the debt/GNP ratio. Corporations, households and the Federal Government have all significantly increased their indebtedness during this period.

These high debt levels may well limit economic growth for many years, for the following reasons: (a) Delinquency rates for consumer loans, and corporate defaults and bankruptcies, have increased sharply, indicating that at least a portion of the economy has become overburdened. Furthermore, for the remainder of the economy, the ability to continue financing a large fraction of current expenditures by borrowing has diminished greatly because debt servicing has increased significantly relative to cash flow and household incomes. In fact, there is evidence that the buildup of corporate debt in recent years is now causing cutbacks in capital spending -- this will not only prevent a stronger economy in 1987, but could actually hinder growth in the longer term. (b) The large buildup of debt has been used primarily to finance budget deficits, consumption, and financial transactions, rather than investment -- thus, it will not yield improvements in productivity, competitiveness, etc. that could increase potential growth, and generate higher incomes to both service the debt and stimulate spending. (c) The massive accumulation of debt in recent years has been financed in part by borrowing from overseas -- the increasing cost of servicing this rapidly growing foreign debt will slow long-term growth by transferring dividends and interest payments out of the U.S. economy.

In addition, the difficulty in servicing the larger volume of debt may make future recessions more steep, especially since any further increase in defaults and delinquencies will weaken the already fragile financial system (bank failures continue to increase even though the economy is still growing). The corporate sector is especially more vulnerable to an economic slowdown, or higher interest rates, because it has not only been adding debt at record levels, but it has also been redeeming equity since 1984, making it more leveraged. The risks associated with the more highly leveraged corporate sector is being exacerbated by the increased portion of bank lending to more risky borrowers.

Economic Restructuring

It is commonly argued that the United States is now going through a major restructuring, from a largely manufacturing to a services-based economy, in the same way that it moved from agriculture to an industrial economy earlier. Furthermore, many argue that this adjustment process is now almost over, so that the economy will begin to grow more rapidly. However, the industrial revolution came about primarily because of rising productivity in agriculture (which freed resources), and resulted in a shifting in resources to even higher productivity manufacturing. Thus, it added to potential long-term economic growth.

The restructuring now taking place is in part being forced by diminishing competitiveness in world markets, rather than because of rising productivity. Moreover, while some of this shift is now into high value-added and productivity activities, involving the use of new sophisticated technology, a large fraction of new jobs are in relatively low-wage, low productivity occupations and industries -- this is holding down overall productivity growth. The current restructuring is also being accompanied by an enormous buildup in corporate debt, which potentially will reduce competitiveness even further (as discussed earlier). Thus, I believe it is optimistic to expect that the restructuring now taking place will produce significantly faster growth in the next five or ten years.

Long-Term Growth Prospects

The combination of poor underlying competitiveness in world markets and high debt levels, combined with relatively slow productivity growth, the continuing loss of high-paying jobs, and other factors, suggests that the pattern of slow growth (by historical standards) that is now underway in the United States may continue for many years. In particular, since some of the factors that permitted the rise in living standards during the 1950s and 1960s are no longer as favorable, since the growth in two-income families and household debt will slow, and since the recent low inflation rate caused by a rising dollar and declining oil prices will not be repeated, spending can no longer grow at anywhere near the rate of recent years. Furthermore, this will represent the other side of trade deficit reduction, so that overall economic growth will not accelerate significantly.

POLICY IMPLICATIONS

While many of our current problems cannot be easily addressed by economic policy, I would nonetheless suggest the following:

(1) Budget deficit reductions remain essential. However: (a) the reduction should be gradual so as not to further weaken the economy in the short term (about $25 billion per year would be reasonable, producing a targeted deficit of about $100 billion in 1991 rather than a balanced budget). Thus, the current Gramm-Rudman-Hollings targets should be abandoned or ignored. (b) Budget policy should be formulated to address other priorities as well. Thus, some additional funding for education, rebuilding the infrastructure,

job training, etc. may be necessary even as budget deficits are reduced -- this will require cutting spending for entitlements by converting some to means-tested programs (at least in part) and by other changes, as well as some revenue increases. (c) Future tax increases should be designed in such a way that they do not further shift the tax burden away from upper-income groups as in recent years. Some tax increases will be necessary, not only to fund key programs, but because the underlying budget deficit outlook is still very poor. In fact, tax reform and the rise in inflation from external sources (i.e., oil prices and the U.S. dollar exchange rate) will make future deficits larger than would have been the case.

(2) There is no way that our competitiveness in world markets can be improved with one simple policy measure. It will require a thorough evaluation of our educational system, our training programs, our military expenditures, our trade laws, etc. It is imperative that this process begin as soon as possible because of the long lag before new actions begin to have a material effect. Trade legislation should focus on improving U.S. competitiveness and opening foreign markets rather than on protectionist devices.

(3) All economic and tax policy actions in the future should be evaluated as to whether they improve U.S. competitiveness and growth prospects before enactment.

(4) As indicated earlier, I would strongly suggest that the Fed maintain an accommodative monetary posture in the near term, despite the rapid growth in the basic money supply -- in fact, some easing moves would be warranted if the economy becomes more sluggish. It will be necessary to slow down the growth in money and credit on a long-term basis, however.

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MONETARY POLICY ANALYSTS FORESEE RECESSION IN '88

Washington, February 18 -- Accommodative Federal Reserve Board policies may be the only thing standing in the way of a 1988 recession, according to a recent survey of the Monetary Policy Forum (MPF).

Disappointed by considerably slower than expected economic growth in recent months, forum members predicted a scant 2 percent gain in the GNP this year and the continued unraveling of positive factors in the nation's economy.

Increasingly pessimistic about prospects for the economy, Forum members, on average, believe there is a 65 percent chance for a recession in 1988. The key factor they cited was a massive accumulation of government, corporate and personal debt that will make it difficult to sustain the current level of demand for U.S. goods.

"The news about the American economy has changed remarkably little for some time," said Lawrence Chimerine, president of the Monetary Policy Forum and chairman/chief economist for Chase

Econometrics. "Indebtedness at home, poor competitiveness in world markets, weak capital spending, and the need to reduce enormous budget deficits will both hold down economic growth and limit our options. Under these present conditions, any change in federal reserve policy that would result in significantly higher interest rates could cause a sizable recession in the next several years," Chimerine stated.

While MPF members said that the weakening dollar would have some beneficial effect on U.S. industry and force the nation's 1987 trade deficit down to about $138 billion, this trend was not expected to reverse the larger negative forces at work.

"Probably one of the most important things we should be doing is to insist that the West Germans and Japan start to rev up their economies with forceful fiscal stimulus," said MPF member George Perry, Senior Fellow, of the Brookings Institution.

In the meantime, Forum members said, the fate of the economy appears to be in the hands of the Federal Reserve Board. The MPF members were unanimous in urging the nation's central bank to stick to its current policies for the immediate future.

Furthermore, they said that the fed should be most concerned about how to avert an economic downturn rather than about too much growth of the monetary aggregates. While they expect some increase in the GNP price deflator this year, forum members said that inflation would remain well under control and that

inflationary concerns ought not to hamper the fed from supplying sufficient credit to move the economy forward.

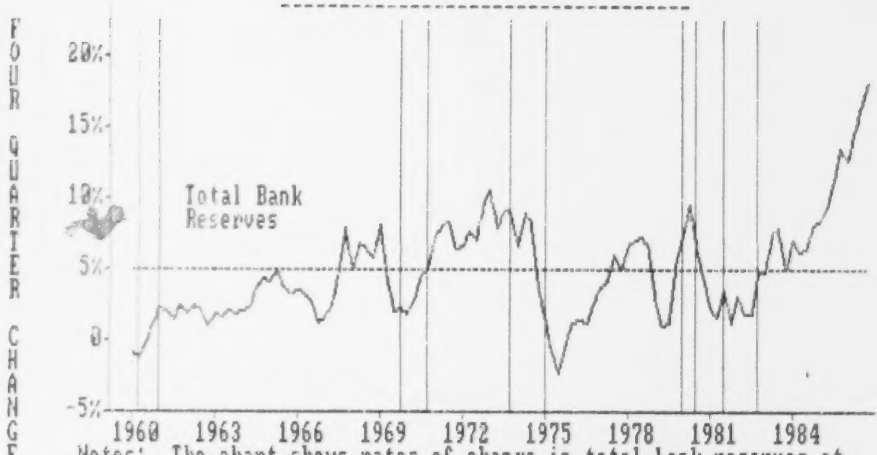
"Any tightening by the fed would affect housing and investment related industries," said Michael Sumichrast, Senior Economic Advisor, National Association of Home Builders. "Housing already shows a sharp 12 percent drop in permits in January foretelling a future decline in this sector," said Sumichrast.

Most of the forum members who were surveyed said that Paul Volcker was their choice for the chairmanship of the fed. The group would have difficulty finding a successor if he should step down.

The Monetary Policy Forum is a group of 28 financial, economic and business analysts.

CHART 1

FEDERAL RESERVE ACTIONS - 1960-1986

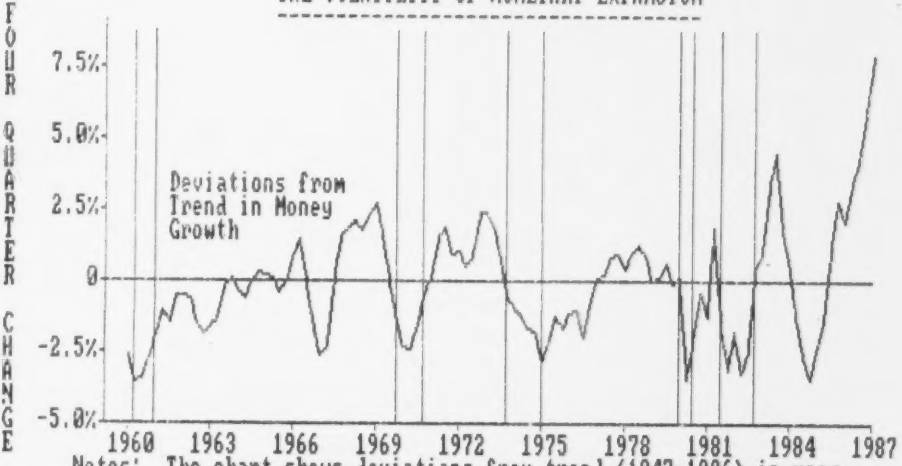


Notes: The chart shows rates of change in total bank reserves at constant reserve ratios. The horizontal line shows the average rate of change, 1960-1986. Vertical lines show periods of recession.

Source: Heinemann Economic Research

CHART 2

THE VOLATILITY OF MONETARY EXPANSION



Notes: The chart shows deviations from trend (1947-1986) in year-over-year changes in the narrowly-defined money supply (M-1). In percentage points. Vertical lines show recessions.

Source: Heinemann Economic Research

The CHAIRMAN. Thank you, Mr. Heinemann.
Dr. Meltzer.

STATEMENT OF ALLAN H. MELTZER, JOHN M. OLIN PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, GSIA-CARNEGIE MELLON UNIVERSITY

Dr. MELTZER. Mr. Chairman, in the 25 years I have appeared before this committee and talked to you and your colleagues about monetary policy and the economy, there are few periods in my judgment which have been as critical as the current period.

I want to discuss two topics with you. First, is the monetary policy which is the subject of these hearings; and, second, the problems of trade and debt, a critical national issue and one which will make a great difference to the living standards of our population for years to come. Let me begin with monetary policy.

In my opinion, we are back to the fast-break and slam- dunk monetary policy of the past with a vengeance. Whatever statements may be made to the contrary, we are printing money at a shameful rate.

This policy is counterproductive. It is going to cause more problems than it will solve.

DEVALUATION OF THE CURRENCY

Our problem is not solely with the Federal Reserve. The Treasury seems to know no solution except devaluation of the currency. The administration has not had the judgment to offer policies other than devaluation. It acquiesces in faster money growth in the hope that it will relieve the current problems of trade and debt.

The Congress has not required disciplined monetary and fiscal policies. It has not demanded that the Federal Reserve adhere to its policy announcements. It has not insisted that the Federal Reserve choose a target that it can control and then carry out the policies which it announces at these meetings.

Elsewhere in these halls, the Congress is investigating the damage to the United States caused by our policy toward Iran that occupies the headlines. The cost to the American people of the Iran problem is small compared to the policies of inflation and devaluation and the effects that those policies will have on the living standards of the American people.

I fully share your view, Mr. Chairman, that the hearings that you are holding are critical hearings, and the policies that you are discussing are critical, not for the short-term outlook for the economy, but for the longer term, for the living standards of the American public.

These policies—the policies of monetary expansion and devaluation—can only work to the extent that they reduce the living standards of the American public and raise the cost of consumer goods to the American public.

Whatever Mr. Volcker may say about his concerns about dollar devaluation, the agency he heads has worked toward that goal and is working toward the devaluation of the dollar by printing money at an extremely rapid rate.

There is, in my opinion, no other way to explain the devaluation of the dollar, in face of the sluggish performance of the rest of the world economy compared to the U.S. economy, other than the fact that the United States is contributing to the devaluation by an extraordinarily high rate of monetary growth.

Let me examine the policy from two aspects. First, can faster monetary growth and monetary devaluation solve the trade problem? The answer is no. The problem is a real problem, not a monetary problem. It arises from spending, mainly for consumption, in excess of production in both the private and the public sectors.

As a nation, we spend too much relative to what we produce. We borrow to pay for the excess of consumption—mainly consumption—leaving debts to the future that will to have to be paid out of incomes that we earn in the future. That's where the drop in the living standard will come from. In the future, we will leave a large debt and that debt will have to be paid by people working more and consuming less. In order to service our debts we must in the future produce more than we consume.

Inflation can contribute to the solution, but only for a time and only by fooling people and reducing their living standards. Eventually, we will pay for the inflation with a painful period of disinflation that the public will demand. We will be poorer as a result of that policy.

Mr. Chairman, on all sides we hear voices urging faster money growth claiming that the economy is weak. This, in my opinion, should be labeled as hokum. Faster money growth stimulates demand. Our problem is not demand. Demand and spending has grown rapidly, above the average rates of expansion for most postwar expansions, and demand continues to grow rapidly.

SPENDING FOR CONSUMPTION

Our problem is that we are not producing domestically the goods to satisfy that demand. We are importing them from abroad. Consequently, we have a large trade balance. Our problem is that we are spending most of the money that we are borrowing for consumption, not for investment. If we were spending more for investment, we would have the resources in the future to retire the debt that we have put out and to service that debt. Because we spend mainly for consumption, we live better now at the expense of the future.

Because the Government budget is devoted mainly to consumption and not to investment, there, too, we are borrowing to spend for consumption.

We must look behind the paper veils of the deficit and the monetary growth to ask about the use of resources in this country. Our use of the resources is principally for consumption, which runs at a near record rate, while net investment runs at one of the lowest rates of the postwar period.

Our problem is, as I have said, that we consume too much relative to what we produce. We cannot solve that problem by faster money growth.

Nor is it true that faster money growth can solve the problems of the farmers, the real estate operators, the oil patch, the insolvency

of the thrifts or the international debt. Faster inflation will be a temporary palliative, but it will bring us back the same kinds of problems that we had in the 1970's.

Many of the problems to which I referred are the result of inflation. A high rate of inflation encouraged people to borrow and bid up the prices of assets; then a severe and rapid disinflation brought down those asset prices and left people who had invested based on the expectation of a continuously high inflation—left them holding assets which were of lower value than they had anticipated.

The problems of farming, real estate and so on are largely a consequence of the slam-dunk monetary policies of the past 10 or 15 years, policies which are now returning.

Senior policy makers brought the inflation down, in my opinion, too quickly. Once inflation was brought to the 3 to 4 percent range, they believed that the problem was largely over. That, of course, was a mistake, a mistake that has been often repeated in monetary history.

The rate of increase in output prices had adjusted downward, but asset prices had not. The adjustment of farm prices, oil prices, land prices and real estate prices to the lower expected rate of inflation is the cause of many of our current problems. It is a mistake to restart inflation and to bring back the problems of inflation and drainflation 5 or 10 years from now.

Having paid a high price to make part of the adjustment, it is a mistake to reverse direction, restart the inflation, and suffer another round of slam-dunk policies. Yet that, it appears to me, is what we are doing.

Most of my written statement is concerned not with the problems of inflation but with the problems of trade and debt.

Mr. Chairman, we must recognize that these problems are interrelated. By the end of this decade, the United States will owe I think on a conservative estimate somewhere between $600 and $900 billion to foreigners. In 4 years, we have moved from being a net creditor position of $150 billion to a net debtor position of $200 billion or more. In 4 more years, I estimate we will add another half a trillion dollars to our foreign debt. We will be paying interest of $60 billion a year to service that debt.

We must earn that interest by producing more than we consume. My calculations suggest that as a Nation we cannot turn the trade balance and pay the interest to foreigners that we will owe without reducing both our relative and possibly our absolute standards of living. Most likely, both.

In my written comments I discuss four solutions. Each is painful. In my opinion, the least painful is to adopt policies that increase productivity. We must invest more and consume less, both publicly and privately. In my opinion, we should institute policies of this kind promptly. We should tax consumption and remove taxes from investment to reduce private consumption and increase private investment.

We should cut Government spending for consumption and increase Government spending that encourages productivity by building infrastructure and helping the productivity that will promote better jobs and higher productivity in our economy.

We should stabilize policies, provide greater certainty about the future. We could look to Japan as an economy which has relatively stable policies and much lower interest rates as a result of the lack of the risk premiums. There is much greater certainty in Japan about what the Government is going to do, and we might look at the fact that Japan, a nation which is consuming far less than it produces and exporting the balance, is shifting its tax rates in a direction that I think we should be shifting ours—removing taxes from investment and shifting them onto consumption. We should be doing the same and more.

We should develop different and more useful approaches to the Latin American debt. I discuss some of these in my paper. The United States is a debtor country now. It cannot lend to Latin America so that Latin America can solve its problems unless we sell assets or borrow to make those loans.

As a net debtor and a borrower in international markets, when we borrow to lend to Latin America that adds to the U.S. debt and the interest we must pay in the future.

This is a critical period. I believe we are in danger of slipping back into the chaos of the interwar period. For 40 years, the United States used its wealth and power to provide a political, financial and trading order. Our relative wealth and power has diminished. We are embarked on a course likely to weaken our absolute position. We have given little thought to who, if anyone, will provide stability in the world in which we now live.

Today, we are discussing monetary policy and economic policy. But the more general subject is the world financial and trading system and further removed the political stability of the world.

It is a serious mistake to sacrifice that stability, as we have, without knowing what will take its place. But that is what we are doing and we will come to regret it.

Thank you, Mr. Chairman.

[The complete prepared statement of Allan H. Meltzer follows:]

Statement by

H. ERICH HEINEMANN

Chief Economist, Moseley Securities Corp.

Committee on Banking, Housing and Urban Affairs
United States Senate

February 18, 1987

Mr. Chairman, I am delighted once again to discuss the conduct of monetary policy with this distinguished committee. The Committee on Banking, Housing and Urban Affairs has long played a vital role in the debate about monetary policy. I look forward to tough questioning today.

Mr. Chairman, we are meeting at a crucial point in the history of the Federal Reserve System. For more than two years, the Federal Reserve - with the active encouragement of the Administration - has been monetizing the Federal debt at progressively more rapid rates. In January, according to Federal Reserve data, total reserves in the American banking system averaged $56.7-billion, 23.8 percent higher than the same month last year. To put this statistic in context, the average annual growth in bank reserves over the past 25 years was a little less than 5 percent.

Keep in mind that the effective reserve requirement in the U.S. banking system is only about 2.8 percent. This means that for every dollar the Fed adds to the reserve base, the banking system can create almost $36 of additional deposits and/or loans and investments.

Over time, ripple effects from this rapid expansion of liquidity will spread through the economy. Total debt will continue to increase more rapidly than GNP. Prices of imported products will rise. The risk of general reflation will mount. Our foreign creditors, who are sensitive to this inflationary potential, will become increasingly reluctant to lend us the $3-billion per week that we need to balance our books. They will lend us what we need, but not at a price we can afford to pay. The dollar will decline further. Interest rates will rise. Another recession will loom on the economic horizon.

Mr. Chairman, monetary growth has already reached such an extreme level that correcting the excess will inevitably involve a significant real economic cost. As usual, those least able to afford it will bear much of the burden. However, further delay in bringing monetary growth under control would only increase those costs. The issue confronting Congress, the Administration and the Federal Reserve is not whether interest rates will rise, but when and by how much.

The obvious short-run costs notwithstanding, I believe the Federal Reserve should implement the following actions at once:

First, take immediate steps to reduce the rate of growth in the "high-powered" reserve aggregates - the monetary base and total bank reserves - to levels consistent with the Fed's own stated, but generally ignored, guidelines for noninflationary monetary policy.

Second, eliminate short-term interest rates as targets for monetary policy. The Federal Reserve itself identified interest-rate targeting as an important contributor to creating the inflation of the 1970's. Yet the monetary authorities have drifted back to de facto targeting of rates as their principal means for implementing policy.

Third, establish a target for growth in the monetary base and adhere to it over a reasonable period of time, say, one year. The Federal Open Market Committee should not publish multiple policy targets, and then decide to focus on whichever target appears consistent with the FOMC's preconceived ideas about interest rates. The Fed should not establish targets for money growth and then regularly ignore them. It is misleading to publish targets and subsequently disregard them.

Fourth, play fair with the American public. Let people know that the current policy of easy money and competitive devaluation has been designed to produce a faster rate of inflation and a decline in the relative real wages of American workers. Admit that if inflation does not speed up, and relative real wages do not decline, then the U.S. trade balance will not improve. Come clean that if the external value of the dollar declines, its internal value will drop as well.

The background for these recommendations is straightforward: The 23.8 percent rate of gain in total bank reserves over the past year was the fastest for a comparable time span in the postwar period. It was a rate of gain more appropriate for a high-inflation country in Latin America than the United States. Moreover, despite the Fed's efforts to flood the markets with money, short-term interest rates have shown a modest upward bias for several months.

So far, the domestic economy has seemingly shown little response to the flood of liquidity from the Federal Reserve. It is true that Fed policy has fomented wild speculation in the stock market, and the value of the dollar has plunged on world financial markets. However, the reported growth rate of GNP has remained sluggish. Reported rates of inflation have been at exceptionally low levels in recent months.

Will the pattern of the recent past continue? Many people believe so. A widespread complacency about monetary policy has developed both among government officials and participants in the financial markets. The income velocity of money (the ratio of GNP to money supply), has dropped. Many think it will keep on dropping. In popular terms, the Fed can print all the money it likes, but no one will spend it - at least, not to purchase goods and services, only to bid up prices of financial assets.

In my view, this is a simplistic and dangerous assumption. It is unsupported by empirical analysis. As my colleague Robert H. Rasche of Michigan State University has demonstrated, recent declines in velocity are not likely to persist. Once allowance is made for the break in the trend of velocity in the early 1980's, he reported, "velocity and aggregate money demand functions remain valid and useful macroeconomic concepts." In layman's language, if the Federal Reserve prints money without restraint, inflation will be the inevitable result.

As the Bundesbank, the West German central bank, warned recently, "there are hardly any definite signs that the substantial money balances accumulated in the course of this year [1986] are being maintained voluntarily by enterprises and households over the longer term." The Bundesbank's caution was of course addressed to the German, not the U.S., economy; but the admonition was just as appropriate in this country.

I find cold comfort in the current subdued rate of inflation and in the fact that the broad monetary aggregates - M-2 and M-3 - have generally been expanding within their assigned target ranges. In my judgment, the extended disinflation of the past two years chiefly reflects two factors:

One, the lingering after-effects of the severe over-valuation of the dollar in 1983 and 1984; and, two, the drop in the price of oil.

Both these influences have now reversed. As we saw in the report of producer prices during January, energy prices have started to climb. Prices of imported products other than oil were up 8.4% in the year ended December. I expect these increases in the cost of imported products to accelerate and to have a progressively more important impact on the domestic price level during 1987.

As for the comparatively slow rate of growth in the broadly-defined monetary aggregates, remember that most of the components of M-2 and M-3 are not subject to the Fed's reserve requirements. Thus, for the most part these aggregates do not speed up and slow down in response to policy actions by the central bank.

Rather, changes in their growth rates reflect portfolio decisions by the public concerning the form in which it chooses to hold financial assets. The past year, for example, has witnessed an extraordinary expansion in public holdings of mutual funds, especially bond funds.

Lured by double-digit rates of return on "government" bond funds, investors poured roughly $200-billion into mutual funds last year. Much of this increase involved shifting funds from accounts at depository institutions, which are included in the "M's," to the funds, which are not.

The high returns that the bond funds are advertising typically represent an amalgam of interest income, trading profits as well as income from aggressive operations in the futures markets. When these reported premium yields evaporate, as they inevitably will once interest rates start to rise, don't be surprised to see the growth of M-2 and M-3 shoot above the Fed's targets. Investors will move their money back to the safe haven of guaranteed returns on insured accounts at banks and thrifts.

Repeated assaults on the dollar in the foreign exchange markets in recent weeks represent fair warning that foreign investors are becoming increasingly alarmed at the inflationary implications of current Federal Reserve policy. According to the Federal Reserve's flow-of-funds accounts, foreign savers supplied more than 15 percent of total funds borrowed in the U.S. last year. Overseas investors are now the principal marginal suppliers of funds to our credit and capital markets.

The U.S. deficit on current account, which summarizes our short-run dealings with the rest of the world, is presently running at an annual rate of about $150-billion. In effect, the U.S. economy must borrow almost $3-billion per week from savers abroad to finance its net imports.

Every time a foreign monetary authority intervenes in the exchange markets to support the dollar, this is an indication that investors in that country were reluctant to acquire additional dollar balances at the existing price for the dollar and/or current dollar interest rates. The funds were dumped on the central bank, which in turn invested in dollar assets at what amounted to a subsidized rate.

In my opinion, it is especially dangerous to assume - as do both the Administration and the Congressional Budget Office - that we can finance our current account deficit at declining real interest rates. Based on my analysis, inflation will accelerate substantially this year.

If the Federal Reserve were to try to force short-term interest rates down by one or two percentage points at the same time inflation was accelerating, the dollar would decline substantially in the foreign exchange market. The dollar, which was severely overvalued in 1984, would become severely undervalued in 1987. The extended disinflation of the past three years would give way to significant new inflationary pressures, sharply higher interest rates and, ultimately, a major recession.

The Federal Reserve has already pushed monetary expansion to such an extreme that a period of rising interest rates and at least a mild recession is now probable in the next 12 to 18 months. To repeat, the principal question confronting participants in the financial markets this year is not whether interest rates go up, but when and by how much.

The pace of business activity is very likely to accelerate substantially in the first part of 1987. A powerful turnaround in U.S. foreign trade, already underway, will reinforce a solid underpinning of domestic demand - which has advanced at an exceptional rate of almost 5 percent during the first four years of the current business expansion.

The Federal Reserve will find itself caught between Scylla and Charybdis. No one wants recession, least of all the Federal Reserve. The manufacturing sector of the economy has been sluggish; agriculture is suffering from a variety of ills; financial institutions are shaky; the festering sore of the crisis in Third-World debt is far from cured, and, not the least, a Presidential election is looming.

However, the fire of speculation the monetary authorities have ignited on Wall Street is symptomatic of the impact easy money is having on inflationary expectations in this country. Members of Congress should be concerned how far and how fast it will spread.

If the Fed were to continue pumping reserves into the banking system at rates between 20 percent and 50 percent in the face of strong growth, you should expect foreign investors to desert the dollar in droves. The incipient crisis in the foreign exchange markets would become a reality.

Mr. Chairman, one of government's bedrock responsibilities - not only in the United States but in all nations - is to provide its citizens with honest money. "Honest money," by any realistic definition, is money with stable and predictable purchasing power. When private citizens make contracts, whether they concern the lease of an apartment or the buyout of a major corporation, they have a right to anticipate that the outcome of the transaction in real terms (adjusted for inflation) will bear some reasonable resemblance to the original intentions.

However, such results are hard to achieve in a world where monetary policy has become increasingly more volatile. In recent years, there have been only two settings for the monetary throttle in the United States: too slow and too fast. Consider the following record:

MONEY SUPPLY GROWTH RATES
Year-over-Year Changes in Percent

Period Ended	Change
Third Quarter 1979	8.28%
Second Quarter 1980	4.31
Second Quarter 1981	9.90
Fourth Quarter 1981	5.00
Third Quarter 1983	13.04
Fourth Quarter 1984	5.44
First Quarter 1987	17.30 (Est.)

With the Federal Reserve constantly running from one side of the economic ship to the other, it has become increasingly difficult to predict the impact of monetary policy on the economy. The risk that we may capsize has risen. It is hard to see a strategy of monetary policy that relies on progressively larger oscillations in monetary growth leading to stable macroeconomic performance.

Such uncertainty carries a high cost in excessive real interest rates, misaligned currencies in world financial markets, lost investment, employment and real growth. Economic history carries the unmistakable message that, over time, such costs can be avoided only if the nation's central bank maintains reasonably stable and moderate rates of expansion in relevant monetary aggregates.

However, the money managers at the Federal Reserve Bank of New York spend most of their time trying to manage conditions in the short-term credit markets. If the manager of the Federal Open Market Account, Mr. Peter Sternlight, is faced with a choice on a given day between maintaining a defined growth path for bank reserves and a defined level of interest rates, he invariably tries to stabilize interest rates.

Since last September, short-term interest rates have shown a modest upward bias, but the month-to-month change in bank reserves has averaged more than 30 percent. The Fed has had to flood the market with high-powered money to keep interest rates from rising even more sharply. To use a sports analogy, Mr. Sternlight is now sprinting in order to stand still.

This is not, I repeat, not, a short-term phenomenon. The sustained decline in interest rates since 1984 has been systematically associated with accelerated rates of expansion in all of the relevant monetary measures. When, and at what level of growth in high-powered money, will this process come to an end? Fifty percent? Five hundred percent? Unfortunately, there is little guidance from the Federal Reserve. Its officials regularly repeat their standard rhetoric against inflation. But their actions belie their words.

In an important address last week, Mr. David A. Stockman, former director of the Office of Management and Budget, accused his erstwhile colleagues in the Reagan Administration of deserting "hard money" as a major goal of policy. He charged that this commitment was now "long gone; abandoned. On the evidence of the last two or three years, we have turned to running the printing press with reckless abandon. We have gotten away with it for a while, but we may be fast coming to the end of that era."

"We have an Administration," Mr. Stockman added, "that is conducting an overt, obvious and unprincipled international policy of bashing our own currency. We have an Administration that articulated a supply-side notion of how you get economic growth and wealth creation now simply resorting to international demand stimulation."

I hope that Mr. Stockman's pessimistic assessment is not correct. But I fear that it may be.

Several years ago, Herbert Stein, former chairman of the President's Council of Economic Advisers, took the Federal Reserve to task for its lack of long-term strategy. "There is no evidence," Mr. Stein said, "that the Fed is committed to any long-run objective." With due allowance for Professor Stein's fondness for political hyperbole, there is truth in this assertion.

As a result, Wall Street - where market participants make handsome livings by putting a present value on future uncertainty - is fascinated with the Fed's daily machinations. But in my opinion, this Committee should take a broader view. Congress can make a lasting contribution to the goal of achieving honest money in the United States by insisting that the Federal Reserve implement consistent and predictable policies that over the long pull will encourage a stable price level.

Once again, thank you for the privilege of participating in your discussions here today.

Statement to the Senate Committee
on Banking, Housing and Urban
Affairs - February 18, 1987

TRADE AND DEBT

By Allan H. Meltzer

Few subjects have received as much comment in recent years as the so-called twin deficits in the Federal budget and in net exports of goods and services. Many economists and most politicians point out the dire consequences of the budget deficit for the future of the economy and of the trade deficit for the future of domestic manufacturing. The deficits are blamed for high interest rates, weakness in manufacturing output and sluggish growth of employment at home.

Yet, despite the frequent discussion of these deficits for four years, the central problem has escaped attention. Few have tried to look through the paper transactions to the reality that lies below. Had this been done, the deficits would appear as symptoms--not causes--of the problems of the U.S. economy. And, while there are no easy solutions, some of the proposed solutions--protection, currency devaluation, easier monetary policy, general tax increases--would be seen to be mistaken or less attractive than some available alternatives.

THE PROBLEM

The main economic problem is that as a nation we consume too much relative to what we produce. The excess of spending over production shows up in the national accounts and affects both deficits. The government spends mainly for consumption--health, welfare, most of defense spending--and very little on investment. Privately, the share of spending for consumption remains near the highest rate we have experienced, while net investment remains at a very low rate. To maintain spending in excess of production, we sell assets and borrow abroad. The counterpart of this borrowing is the trade deficit--net imports from abroad. For the last year, net imports have remained at about 2.5% of total output--about $150 billion in constant 1982 dollars.

In the past four years, we have borrowed so much that, instead of owning net foreign assets of nearly $150 billion, as at the end of 1982, we had net foreign debts of more than $200 billion at the end of 1986. Large borrowing will continue even on the most favorable assumption. By the end of the decade we will owe foreigners between $600 and $900 billion.

These numbers seem large in an absolute sense, and they are. The U.S. is a wealthy country, however, with assets of from $10 to $15 trillion and with gross foreign assets of $1 trillion or more. Visions of U.S. citizens living in homes, or working in factories and office buildings all of which are owned by foreigners remain far from reality.

Still, there is a sense of unease. We accumulated the stock of foreign assets over a period of 70 years. In just four years, we have wiped out the net accumulation of several generations.

Should we be disheartened and ill at ease? Are a foreign debt and trade deficit of this size good or bad for the economy? The answer depends not on mainly the size of the deficit but on how the resources obtained through borrowing and net imports are used. If our borrowing financed a high rate of productive investment, the returns on the investment would pay the interest and principal. Our future standard of living would be higher. Since borrowing is used mainly to finance consumption, we live better now but leave a debt to be serviced and paid in the future. At some time, we or our children will be faced with two options.

Since our international borrowing is denominated in dollars, one option is to reduce the real value of the debt by inflating faster than people now believe likely. Increased inflation reduces the real cost of paying interest on the debt. Inflation imposes a large cost on the foreigners who bought the bonds and, as recent experience with inflation and disinflation shows, there are large costs at home also. The precise effect on international monetary arrangements of another period of U.S. inflation cannot be predicted. A new monetary arrangement may emerge, or we may return to the chaos of the 1930s.

The second option is to service the debt without inflating. This requires producing more than we consume and selling the surplus abroad to pay the interest on the foreign debt. This option requires a trade surplus for the U.S. large enough to cover net interest payments abroad. Using an interest rate of 8% and a net foreign debt of $600 billion to $900 billion, our trade surplus has to remain at $50 to $70 billion per year indefinitely. A larger surplus in any year would reduce the debt and future interest

The CHAIRMAN. Well, thank you very much, Dr. Meltzer.

Dr. Roberts.

If I could interrupt just for a minute, without objection, a statement by Senator D'Amato will be inserted in the record at this point, and I apologize. Go right ahead, sir.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I commend the chairman for inviting the witnesses to appear today, one day before Federal Reserve Board Chairman Paul Volcker is scheduled to testify. This morning's testimony should provide the committee with an appropriate context through which we can evaluate the content of Chairman Volcker's remarks.

The testimony from today's witnesses reemphasizes several points that have been made to the committee in the past regarding the stability, or should I say the relative instability of our domestic economy. Today's testimony substantiates the assertion that economic forecasting is hardly a precise science. However, certain steps must be taken by the Congress, the President, and the Federal Reserve Board to ensure continued and stable economic growth.

If the economy continues to grow at a moderate rate and if we are going to introduce more stability into the domestic and international economies, then Congress must address two problems that no longer loom on the horizon—these problems are at the front door. The first problem is that the Budget deficit must be reduced in a rational and least painful manner as possible. The deficit issue has become a political football with the Congress blaming the President and the President blaming a profligate Congress. Such accusations tend to exacerbate rather than resolve the problem. I am interested in the testimony of Paul Craig Roberts who introduces in his testimony another culpable party in the deficit debacle—the conduct of monetary policy by the Fed. I hope he will elaborate on this point during the hearing. I also hope each of our witnesses will offer their recommendations on how the budget deficit may be cut and whether they think Gramm-Rudman is effectively accomplishing its intended goals.

The second problem confronting our domestic economy is the trade deficit. Frankly, I am tired of hearing the same old arguments about how Americans can't compete; the unions have priced American heavy industry out of the market; and America is losing its technological advantage. I believe these arguments and those advancing draconian protectionist legislation ring hollow when one takes a real look at what's happening to American industry.

American Industry is at the forefront of innovation. U.S. companies spend billions on innovation each year and develop new technologies. However, before these new technologies can be put to practical uses, we find that our foreign competitors are using the same technologies, in practical uses, at lower costs. How can they do this? Easy, many of our competitors are stealing us blind. During our last hearing on the Federal Reserve's monetary policy report, I stated that our so-called trading partners:

> Steal our patents, intellectual property rights, systematically are adjudged guilty in the courts, say we're sorry, pay back penalties, continue the same thing, infringe on patents and then send the products here into the United States. Further, those harmed have limited recourse under the current legal system. At present, even

though your copyright may have been infringed or your patent stolen you must then demonstrate that there is substantial danger to the particular industry, before damages can be awarded. Despite the failure of the laws and trade policies pursued to date we hear, oh, yes, we're going to make changes. We've been waiting a long time for negotiations or other bilateral approaches to work. We wait in vain. It seems to me, absent any legislative action or some very real enforcement of present trade practices, the policies of the Japanese and others will not change because they lack any incentive to change.

I have not changed my point of view on the subject. I should also note that Chairman Volcker supported my notion of the cause of such competitive trade imbalances and urged us to act. I am sorry to state that in the drive to make America more competitive, we and the Administration have yet to consider the steps needed to make technological piracy more punitive.

I look forward to the testimony of today's witnesses and would hope they shed some light on the accuracy of the Administration's predictions about GNP growth and the chances of increased inflation if the Fed continues its current monetary policies.

STATEMENT OF PAUL CRAIG ROBERTS, WILLIAM E. SIMON CHAIR, POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Mr. ROBERTS. Thank you, Mr. Chairman.

Monetary targets fell into disrepute in the 1980's as M1 lost its predictive quality. I think it would be mistake to conclude from this that the targets don't matter or that money doesn't matter.

To the contrary, the main reason for the large budget and trade deficits today is that the Fed followed an overly restrictive monetary policy in 1981 and that it had an inappropriate target in 1982, one it was forced to abandon after mid-year in order to combat a severe recession and a foreign debt crisis symbolized at the time by Mexico's inability to pay its foreign creditors.

In discussing the economic outlook, many people often speak as if everything depends upon fiscal policy. This has particularly been the case in policy discussions about the U.S. budget and trade deficits. If belief in the primacy of fiscal policy gets out of hand, it could downgrade the importance of monetary policy and the oversight responsibilities of this committee.

In my opening remarks I provide an empirical demonstration of the power of monetary policy. Indeed, whether or not the fiscal actions of Government produce the desired results depends upon whether or not the Fed conducts monetary policy in keeping with the monetary policy assumptions in the budget.

GROWTH RATE OF NOMINAL GNP

The key to any budget forecast is the assumption made about the growth rate of nominal GNP. If the Fed conducts monetary policy in a way that causes the inflation rate and the real economic growth rate to diverge from the assumptions or goals in the Government's budget, the Government will collect either more or less revenues than it expected, and it will spend more or less in real terms than it intended. In the 1980's inflation fell relative to expectations, causing the Treasury to collect less revenues than expected

and causing the Government to spend more in real terms than it intended.

As tables I and II in my testimony show, the conduct of monetary policy is resposible for about 46 percent of the buildup in public debt during the 1981–86 period.

Mr. Chairman, the collapse of inflation was a good thing, but it was nevertheless hard on exporters, farmers, the energy industry, and the deficit. The powerful disinflation cut more than $2.5 trillion from nominal gross national product over the 1981–86 period. The budget effects of this are shown in table II. I will pass over those in the interest of time.

The same unexpected disinflation that caused the budget deficit also caused the dollar's rise in value and the U.S. trade deficit. It is impossible for the inflation rate to unexpectedly drop from double-digit rates back to the low single-digit rates of the 1960's without the dollar rising in value. The Fed should have understood that it cannot simultaneously make the dollar a more desirable currency in which to hold assets and fail to meet the increased world demand for dollars without the dollar rising in value. As chart I in my testimony shows, the dollar has consistently risen with deceleration in the growth rate of money and fallen with acceleration in the growth rate of money.

The same tight monetary policy that drove down inflation and made the dollar more desirable also curtailed the supply of dollars. The result was a steep rise in the dollar's price, or exchange value. The Federal Reserve did not accommodate the higher world demand for dollars, thereby keeping upward pressure on the dollar's value. In 1984, the Federal Reserve again tightened, simultaneously taking the bloom off a robust expansion in the real domestic economy and driving the dollar higher.

In the face of the abrupt change in U.S. monetary policy and inflation, nothing could have prevented the rise in the dollar. Indeed, not even large budget deficits, which normally depress a currency's value, could prevent the dollar from rising. Smaller deficits would have added to the confidence factor and driven the dollar even higher.

ACCELERATION OF M1

Turning to the current situation, since the first quarter of 1985, money growth, as measured by M1 and total reserves, has accelerated. I am not convinced that these growth rates are signs of an inflationary policy, but many people have interpreted them that way and rapid money growth can explain the decline of the dollar without anything having been done about the budget deficit, which was supposed to be the cause of the high dollar.

Another explanation for the dollar's decline is that a new liability has risen to take the place of double-digit inflation in depressing the value of the dollar. That new liability is the buildup in debt owed to foreigners as a result of the trade deficit caused by the sharp rise in the dollar's value in 1981 and in 1984. As our debtor status deepened, the dollar turned around and began falling.

Mr. Chairman, to work our way out of our trade deficit requires not just a weaker dollar but an expanding world economy.

We might not get one. Now that the dollar's decline is the focus of attention, the Federal Reserve is feeling pressures to raise interest rates to save the dollar and forestall a renewal of inflation due to rising import prices. I am not confident that the debt structure at home and in the debtor countries that owe our banks so much money is strong enough to accommodate a tightening of monetary policy. I am not confident that the economy is robust enough at this point to stand monetary tightening. There seems to be enough evidence that we are still suffering the effects of severe deflation from past monetary policy. Commodity prices have not broken out on the upside, capacity utilization is not high, and the latest Fed data show a continuing deterioration of the farm banks despite the massive federal subsidies to farmers.

In general, I am somewhat skeptical the economy is strong enough at this point to stand tightening.

Mr. Chairman, I have in my testimony comments about the growth of M1 and total reserves. I am not certain that these are reliable indicators for reasons that I indicate. I note the continuing decline in velocity and note that that decline is somewhat ambiguous because it can fall for two reasons. It's not always clear which one is the reason that is operative.

I look at some other monetary indicators and see less rapid acceleration in the growth of money than M1 indicates.

I am not a monetarist, but I do believe that money matters. If monetary policy is going to be guided by money targets, they had better be the right targets, and the Fed had better hit them. Otherwise, the Government's economic goals and deficit targets are not going to be met. So far in the 1980's, the Federal Reserve has largely countermanded the Reagan administration's supply-side policy. The benefit of the Fed calling the shots was a more rapid than intended deceleration of inflation. The costs are the large budget and trade deficits and the severe debt crisis that stretches from the American farm community to the Third World.

The breakdown in the monetarist relationships upon which the monetary targets are based may only be temporary. However, in view of the doubts about M1 and the actual conditions in the world economy, the Fed had best watch, for a time at least, a broader range of indicators than monetary aggregates provide. The behavior of commodity prices, the real growth rate of the economy, sectoral strengths and weaknesses, consumer behavior, business confidence and investment, the growth of the world economy, all bear close watching. Without many signs of real strength, it could be a disastrous mistake to tighten monetary policy on the basis of M1 growth and speculation in the exchange markets that the Treasury wants a lower dollar.

Mr. Chairman, That completes my opening remarks.

[The complete prepared statement of Paul Craig Roberts follows:]

payments; a smaller surplus would add to the debt and raise future interest payments.

The change from net imports of $150 billion to net exports of $50 to $70 billion requires a major shift in world trade patterns and resource use. Because the debt remains outstanding, the shift to a surplus must be permanent. A shift of this size, though large by current or past standards is not large in comparison to the size of the U.S. economy. A trade surplus of $60 billion by 1990 will be less than 1½% of real GNP in that year.

The problem cannot be solved in isolation, however. We are not the only debtor. Many other countries have debts that must be serviced also, so these debtors, too, must have trade surpluses if they are to service their debts, currently close to $1 trillion. This limits our options. For example, we cannot expect to solve our problem by increasing net exports to Latin American debtors unless they increase their net exports to Europe and Asia. Nor, can we continue to be a net lender to Latin America to finance their trade and development. Every dollar we lend them has to be borrowed from the rest of the world or earned by exporting more than we import.

There is no way to avoid the conclusion that, if the debts accumulated in the seventies and eighties are to be serviced, there must be a major change in trading patterns and, therefore, in economic and trading relations. The U.S. must become a large net exporter to Europe and especially to Asia. Europe and Asia must become net importers. The postwar strategy of export led growth to finance investment in the countries of Europe, Asia and parts of Latin America was highly successful. Standards of living rose. That strategy must change to reflect the debtor position of the United States.

The magnitude of the required change is impressive. Currently, the U.S. exports about $200 billion and imports more than $350 billion. Closing the gap between exports and imports and paying the interest on its debt is equivalent to doubling the amount of current exports (in constant dollars) by 1990, or reducing current imports by more than one-half, or some combination of the two. These amounts are about 10% of total current world exports and, perhaps more relevantly, more than three times the average trade surpluses (with all countries) of the two principal surplus countries--Germany and Japan. Much of Germany's surplus is earned within the European Economic Community, while much of Japan's surplus comes from trade with the U.S. It becomes clear that these countries must become, for the first time, large net

importers from the U.S. and other debtor countries if the debts are to be serviced. To illustrate, Japanese and German trade surpluses equal to 2% of their 1990 output would provide only $75 billion toward any deficits and interest payments of the U.S. and other major debtors. This is about one-half the amount of 1990 interest payments of these debtors.

Many observers who discuss the twin deficits appear to reach conclusions that are superficially similar. They urge monetary expansion by Germany and Japan to lower interest rates and stimulate demand for our exports. Others urge monetary expansion by the Federal Reserve to depreciate the dollar or monetary expansion in all three countries and perhaps elsewhere. These are stop gaps, not solutions. They work by putting the bandaid of additional demand on a problem that requires adjustment of costs and prices of exports and imports. They offer short-term, not long-term, solutions.

The problems of trade and debt are not mainly problems of weak demand. Output growth in the U.S. has not been held back by weak domestic demand. Consumer demand has been strong, but a large part of the demand has been satisfied by imports. Faster money growth abroad can produce a temporary spurt in world demand, an increase in U.S. exports and a reduction in the trade deficit. But, faster money growth abroad cannot solve the long-term problems of trade and debt. And, by increasing inflation, faster money growth sets the stage for another period of disinflation and another round of stop and go that will make the problem harder to solve.

OPTIONS

To eliminate the trade deficit and service our debt, we must lower costs of production relative to prices. There are four options. None offers an easy, attractive solution. Each deals in a different way with the problems of trade and debt.

We can inflate, as many now urge. Inflation lowers the value of the debt and devalues the dollar. The decline in the value of the debt transfers wealth from the rest of the world but, sooner or later, inflation raises all prices including interest rates and wages. The rise in wages and other costs of production offsets the effect of the devaluation on trade. To reduce the trade deficit permanently, we must reduce the cost of domestically produced goods. Inflation not only does not solve the trade problem but, by

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encouraging consumption, it makes the problem worse.

We can protect against imports using quotas, surcharges and perhaps tariffs. This lowers spending on imports but invites retaliation and shrinks the amount of world trade. A lower level of trade makes more difficult the task of squeezing out $60 billion to pay interest on our foreign debt. In addition to all the other, well advertised disadvantages of trade restrictions, we must add that they are in a real sense counterproductive when we view the trade and debt problems as a whole.

We can devalue the dollar. We have done a lot of that in the past two years. A real devaluation, unlike inflation, raises prices relative to costs of production. The rise in prices makes our exports cheaper, our imports dearer. This method of adjustment, like protectionist policy, reduces standards of living relative to foreigners and perhaps in absolute terms. We cannot avoid devaluation, but we should avoid policies aimed at manipulating exchange rates and "talking the dollar down."

We can increase productivity. There are many ways to do this, none easy to accomplish. At the national level, the four most important policy changes in my judgment, are: (1) without increasing taxes, shift taxation from capital to consumption so that the share of consumption spending falls and the share of capital spending rises to levels substantially above those achieved in the last twenty years; (2) reduce government spending, particularly consumption spending and, if possible, shift government spending from consumption to productivity enhancing investments in infrastructure; (3) make a commitment to maintain these policies--and a long-term pro-growth strategy-- to reduce uncertainty about future after tax returns to investment. Elements of this strategy include more deregulation, less costly means of reducing pollution, enforcing product liability, safety and health. (4) Shift from a policy of lending to foreign debtors to a policy of encouraging repatriation of foreign capital and debt reduction by foreign debtors. It makes little sense for a debtor country, the U.S., to borrow and sell assets to finance loans to Latin American debtors. Instead, we should encourage Latin Americans to sell equity in their large state sectors or to adopt policies that attract some of the capital held abroad by their citizens.

CONCLUSION

The problems of trade and debt require that we produce more relative to what we spend and that we transfer part of the difference abroad to service the debt. The four options take different approaches to the problem. Inflation does little to solve the trade problem. Devaluation (in real terms) and protection solve the problem by lowering standards of living at home relative to living standards abroad. None of these options works to increase output and productivity. A general tax increase to reduce the budget deficit would raise the tax on investment to maintain government spending on consumption. This is the opposite of a policy to close the gap between spending and production by increasing production. It is only by adopting measures that increase productivity that we can hope to service our debt while shifting output from domestic use to exports without increasing inflation and without permanently reducing standards of living relative to foreigners and, perhaps, absolutely. Reductions in government spending on consumption, higher taxes on private consumption and lower taxes on investment and capital shifts resources toward investment and raises productivity.

A few numbers bring the problem into perspective. Interest payments by the end of the decade will be about 1¼% of real output. If real output grows at an average rate of 2½% to 3% per year, output per capita will rise at no more than 2% per year. The interest payments absorb all, or most, of the increase. In addition, we must eliminate the current net exports deficit of 2½%.

These numbers imply that per capita incomes do not rise to the end of the decade, and may fall. If such a fall is to be avoided, the options must include more than inflation, protection and devaluation. A pro-competitive, pro-growth policy achieved through a permanent change in taxation must be part of our policy. This policy does not avoid a reduction in current consumption, but by increasing output per worker, it assures that the reduction is temporary, not permanent.

There is no easy way out. Selling assets buys time, but something must be done with the time that we buy. To avoid having all of the problem solved by permanently reducing the real wages of American workers and the real incomes of American consumers, through inflation, devaluation and protectionist policy, we must begin, now, on a sustained effort to increase

productivity. A shift of taxes from capital to consumption is an important first step. If we could add just one-half percent to the average growth rate for the next four years, we would have $100 billion more available for consumption, exports and investment in 1990.

Much depends on our choices. For the past forty years, the United States has had the relative wealth and power to maintain or impose a degree of political, economic and trade stability on much of the world. We have not always succeeded; we have made mistakes; but, we have avoided the return to the disorder that characterized the interwar period, particularly the 1930s.

If we solve our problems of trade and debt by reducing our relative wealth, we move to a position of co-equal in a multi-centered world. New arrangements must develop for sharing responsibility for defense, finance, trade and the maintenance of such order as can be provided. We have done little to develop arrangements commensurate with the reduced role that our relative wealth and power will bring. If we fail to increase productivity, such planning is essential to avoid a return to the uncertainties of the interwar period.

TESTIMONY BEFORE THE SENATE BANKING COMMITTEE

FEBRUARY 18, 1987

by

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Mr. Chairman, members of the Committee, monetary targets fell into disrepute in the 1980s as M1 lost its predictive quality. I think it would be a mistake to conclude from this that the targets don't matter or that money doesn't matter. To the contrary, the main reason for the large budget and trade deficits today is that the Fed followed an overly restrictive monetary policy in 1981 and that it had an inappropriate target in 1982, one that it was forced to abandon after midyear in order to combat a severe recession and a foreign debt crisis symbolized at the time by Mexico's inability to pay its foreign creditors.

In discussing the economic outlook, many people often speak as if everything depends on fiscal policy. This has particularly been the case in policy discussions about the U.S. budget and trade deficits. If belief in the primacy of fiscal policy gets out of hand, it could downgrade the importance of monetary policy and the oversight responsibilities of this Committee. If people believe that fiscal policy is the whole ball game, they are unlikely to pay much attention to the Fed or to this Committee. Therefore, in my opening remarks I would like to give you an empirical demonstration of the power of monetary policy. Indeed, whether or not the fiscal actions of government produce the desired results depends upon whether or not the Fed conducts monetary policy in keeping with the monetary policy assumptions in the budget.

The key to any budget forecast is the assumption made about the growth rate of nominal GNP. If the Fed conducts monetary policy in a way that causes the inflation rate and the real economic growth rate to diverge from the assumptions or goals in the government's budget, the government will collect either more or less revenues than it expected, and it will spend more or less in real terms than it intended. In the 1980s inflation fell relative to expectations, causing the Treasury to collect less revenues than expected and causing the government to spend more in real terms than it intended.

We have all heard a great deal about the trillion dollars that have been added to the public debt during the last six years. The Reagan Administration blames the Congress for spending too much on domestic programs, and Congress blames the President for cutting taxes too much and for spending too much on defense. These charges and counter-charges have turned the budget into a political football. Moreover, the charges are, for the most part, wrong.

As Table I and Table II in my testimony demonstrate, the conduct of monetary policy is responsible for the lion's share of the buildup of public debt during the 1981-86 period. The unexpectedly and excessively tight monetary policy during 1981-82 caused both inflation and real GNP growth to collapse relative to expectations. Normally, administrations forecast lower inflation than occurs. However, the Reagan Administration forecast higher

Chart III

FRB Monetization: Percent of Deficit

Calendar Years: 1970 – 1986

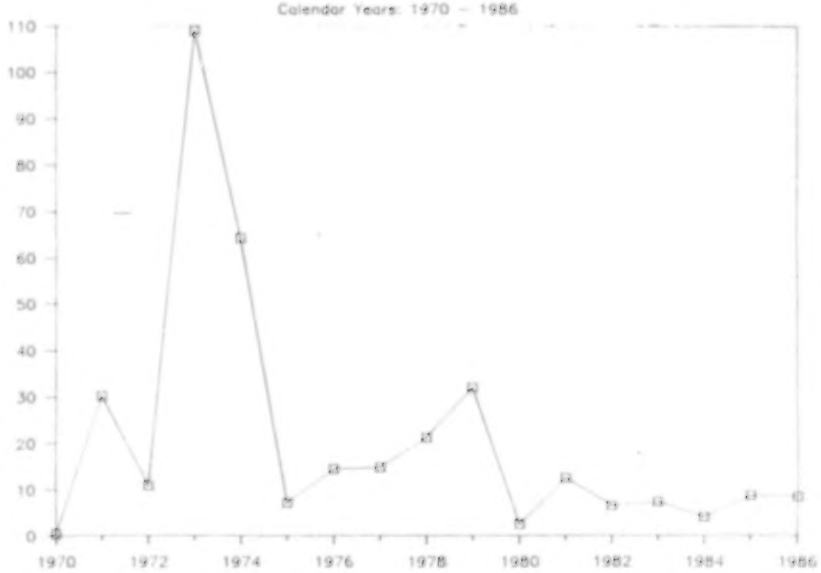


CHART IV

How the Defeat of Inflation Wrecked the U.S. Budget

By PAUL CRAIG ROBERTS

LOS ANGELES TIMES
JANUARY 27, 1987

Federal Reserve Chairman Paul A. Volcker's unsung achievement is the destruction of the budget process in the United States. Consider first the demise of the process, and then Volcker's role in bringing it about.

The budget for fiscal 1982 was the last time that Congress carried out the responsibilities that it gave itself in the Congressional Budget Act of 1974. Since then the budget process has collapsed so completely that even Sen. Pete V. Domenici (R-N.M.), the chairman of the Senate Budget Committee during 1981-86, has affirmed the shambles: "Deadlines are regularly missed," "Senate rules are ignored" and "the year's legislation is compressed into a few major bills, each of them hundreds of pages in length, well beyond the individual member's ability to comprehend or influence."

The budget process of the United States was broken apart by the large deficits of the 1980s, and the abandonment of budget procedures in turn has reduced the U.S. budget to the status of a political football. Indeed, the situation today is little better than a shouting match between the Administration and Congress over who is responsible. The White House claims that the deficit is the result of Congress' refusal to cut domestic spending. Congress claims that the deficit is the result of the Administration's excessive tax reduction and defense buildup. Neither claim is truly correct.

The "triple-digit" budget deficit of the 1980s has a single major cause: the unexpected collapse of inflation. Normally, Administrations predict better performance in reducing inflation than is achieved. The Reagan Administration, however, forecast worse inflation than occurred. This threw the budget off, in terms of both revenues and spending.

Budgets are prepared in nominal terms. So when inflation falls below the forecast, it costs the Treasury revenues. It also means that spending is higher in real terms than was intended. For example, if the government budgets for 10% inflation and by the end of the year inflation has fallen to 5%, the government ends up spending far more than intended and collecting far less revenues than expected. Every year that inflation is overbudgeted adds to the deficit. Indeed, according to former Budget Director David A. Stockman, the more-rapid-than-expected decline in inflation cost the government a tax base equal to half of last year's gross national product—roughly $2.15 trillion.

Although it was hard on the deficit, farmers, exporters and the energy industry, the collapse of inflation was a good thing overall. Nevertheless, it was an accident in the sense that it was not predicted by anyone, including the Federal Reserve that brought it about. The Federal Reserve vastly overestimated the inflationary effect of the 1981 tax cut and, as a result, overcompensated with an excessively tight monetary policy. The cost of curing inflation faster than the Administration had planned was triple-digit budget deficits.

The appropriate response to the deficit is a one-year budget freeze together with Federal Reserve support for a higher rate of real economic growth. The combination of a spending freeze and faster economic growth would quickly cut the deficit and terminate the speculation about U.S. economic credibility.

Even more important, it would end a budget impasse that is now five years old—too long for a democracy to be immobilized by such a critical operating feature as the annual budget. The festering budget stalemate between Congress and the White House has produced an escalation of rhetoric that is undermining peoples' confidence in government and creating concerns abroad.

The budget will cease to be a political football the day that the government explains to the public the effect on the deficit of the unexpectedly quick victory over inflation. The easiest way to put the issue behind us is to adjust the budget to the unanticipated change in inflation with a one-year spending freeze. This approach would avoid the fight over budget shares that has stalemated the government, and it would pose no threat to the Federal Reserve's disinflationary policy or to President Reagan's tax policy. Moreover, it would encourage Volcker to allow faster growth by sending a signal that he would not raise interest rates if the economy picked up steam.

This approach also has the advantage of being one that the public can understand and accept. The deficit is too large to be handled by a rearrangement of budget shares. People can more easily accept the fairness of a freeze that would not alter the relative shares of the various constituencies. Getting the deficit under control is the best way to assure a continuation of the defense buildup, because there is no guarantee that defense can win a fight over budget shares or that higher taxes would be allocated to defense.

Once the politicians adjust the budget for the disinflation, they can resume the fight over budget shares. But the attempt to do both at once has overwhelmed the process. A solution is at hand if the politicians are interested in making government work.

Paul Craig Roberts served as assistant secretary of the Treasury during the first Reagan Administration.

inflation than occurred. Ironically, when the Administration released its forecast in 1981 showing declining inflation over the next five years, it was jeered as a "rosy scenario." The collapse of inflation in 1982 was not predicted by anyone, including the Fed that caused it.

The collapse of inflation was a good thing. But it was nevertheless hard on exporters, farmers, the energy industry, and the deficit. The powerful disinflation cut more than $2.5 trillion from nominal GNP over the 1981-86 period. This reduced tax revenues by $556 billion.

Lower than expected inflation also reduced spending relative to the original forecast for those outlays that are indexed to inflation or whose costs are directly related to inflation. These costs include about two-thirds of the budget and reduced outlays over the period by $198 billion.

The impact on outlays of a higher unemployment rate due to the unexpected and severe recession raised outlays by about $39 billion over the period. The debt service costs associated with the larger than expected deficits added $62 billion.

When these figures are added, unanticipated disinflation caused by excessively tight monetary policy accounts for $459 billion, or 46 percent, of the trillion dollar increase in the public debt over 1981-86.

If we take into account the fact that the Administration forecast a cumulative deficit of $122.5 billion for 1981-83, we have another 12 percent. And if we then add in David Stockman's $40 billion in "unidentified spending cuts," it comes to $120 billion for 1984-86, or another 12 percent.

Altogether that accounts for $700 billion, or 70 percent of the trillion dollars. In other words, only 30 percent, or $300 billion over the six year period, is left to be blamed on tax cuts, defense buildup, and domestic spending. It seems to me, Mr. Chairman, that it is not very productive for Congress and the President to try to blame each other for the deficit when between them they are only responsible for 30 percent of it. I don't think we should send the Fed a bill for the 46 percent for which it is responsible, but I do think it is time for all of us to admit that it is impossible to unexpectedly cure inflation without paying a cost. We have paid that cost, and to keep it from rising we need to make a level adjustment in the budget to bring it in line with the unexpected component in the disinflation. Probably a one-year spending freeze would do the trick as long as it is a year during which we have a pretty good economy.

The same unexpected disinflation that caused the budget

deficit also caused the dollar's rise in value and the U.S. trade deficit. It is impossible for the inflation rate to unexpectedly drop from double-digit rates back to the low single-digit rates of the 1960s without the dollar rising in value. The Fed should have understood that it cannot simultaneously make the dollar a more desirable currency in which to hold assets and fail to meet the increased world demand for dollars without the dollar rising in value. As Chart I in my testimony shows, the dollar has consistently risen with deceleration in the growth rate of money and fallen with acceleration in the growth rate of money.

The same tight monetary policy that drove down inflation and made the dollar more desirable also curtailed the supply of dollars. The result was a steep rise in the dollar's price, or exchange value. The Federal Reserve did not accommodate the higher world demand for dollars, thereby keeping upward pressure on the dollar's value. In 1984, the Federal Reserve again tightened, simultaneously taking the bloom off a robust expansion in the real domestic economy and driving the dollar higher.

In the face of the abrupt change in U.S. monetary policy and inflation, nothing could have prevented the rise in the dollar. Indeed, not even large budget deficits, which normally depress a currency's value, could prevent the dollar from rising. Smaller deficits would have added to the confidence factor and driven the dollar even higher.

Since the first quarter of 1985, money growth, as measured by M1 and total reserves, has accelerated. I am not convinced that these growth rates are signs of an inflationary policy, but many people have interpreted them that way, and rapid money growth can explain the decline of the dollar without anything having been done about the budget deficit, which was supposed to be the cause of the high dollar.

Another explanation for the dollar's decline is that a new liability has risen to take the place of double-digit inflation in depressing the value of the dollar. That new liability is the buildup in debt owed to foreigners as a result of the trade deficit caused by the sharp rise in the dollar's value in 1981 and in 1984. As our debtor status deepened, the dollar turned around and began falling.

It got some ill-advised help along the way. At a meeting at New York's Plaza Hotel in September 1985, Japan and West Germany agreed to help reduce their trade surpluses with the U.S. The agreement itself was fine, but the way it was implemented was unfortunate. They drove down the value of the dollar by tightening their domestic monetary policies to drive up the value of the yen and the mark. Consequently, the Japanese economy went into recession, and West German economic growth slowed. The result was a weaker dollar but also weaker markets overseas for

our exports. To work our way out of our trade deficit requires not just a weaker dollar but an expanding world economy.

We may not get one. Now that the dollar's decline is the focus of attention, the Federal Reserve is feeling pressures to raise interest rates "to save the dollar" and forestall a renewal of inflation due to rising import prices. I am not confident that the debt structure at home, and in the debtor countries that owe our banks so much money, is strong enough to accommodate a tightening of monetary policy. I am not confident that the economy is robust enough at this point to stand monetary tightening. There seems to be enough evidence that we are still suffering the effects of severe deflation from past monetary policy. Commodity prices have not broken out on the upside, capacity utilization is not high, and the latest Fed data show a continuing deterioration of the farm banks despite the massive federal subsidies to farmers. There was a 30 percent increase last year in the number of farm banks with more problem loans than capital. The FDIC's problem-bank list now includes 615 farm banks. Land values are still drifting down in most of the Midwest and the oil states. Massive federal farm payments, which now exceed the value of farm output, have not yet stabilized the situation. I wouldn't think monetary tightening would be helpful to the situation.

I wouldn't think monetary tightening would help the Third World debt crisis or the loan portfolios of their U.S. creditors. Brazil, last autumn's big political success story, is again in economic chaos, and Mexico, the big success story of two years ago, cannot deal with its debt at the current level of U.S. interest rates. Those calling for monetary tightening had better think about all the fallout. It is almost certain to produce bigger subsidies, more bailouts, a weaker economy and a larger budget deficit.

Concern about reflation has been caused by the increase in M1 and total reserves (Table III). These numbers may be reliable indicators. On the other hand, some people may be reading too much into them. A lot of M1 growth can be explained by deposit shifts. For example, when multi-year CDs in savings and loans mature, people are more likely to shift them to a NOW-account in a commercial bank than to roll them over. A shift in funds from M3 to M1 increases total reserves, because reserve requirements against M1 deposits are higher than for M-3 deposits. If total reserves rise because of deposit shifts, it is not an indication of an expansionary monetary policy. The broader aggregate, M3, does not show an increase in money growth. Indeed, the quarterly rates of growth of M3 for the past two years are lower than the quarterly growth rates during 1981, 1982, 1983, and 1984, a span that included periods of monetary tightening.

Moreover, rapid M1 growth is offset by a continuing decline

in velocity. The decline in velocity is itself somewhat ambiguous, because velocity can fall for two reasons: (1) It can fall because inflation falls and people are more willing to hold money, and (2) it can fall because a spurt in money growth causes money to grow faster than nominal GNP. If velocity has fallen because of the first reason, the double-digit M1 numbers of the past two years do not signal reflation. If velocity has fallen because of the second reason, sooner or later nominal GNP will catch up with money growth. As Chart II in my testimony shows, the fall in velocity dates from 1981 and includes periods of monetary tightening and monetary ease (as measured by M1).

It is possible to factor out much of the noise in the M1 numbers by looking at M1-A (demand deposits plus currency). This eliminates deposit shifts from M3 saving accounts to M1 saving accounts. M1-A shows no inflationary acceleration in growth until the second quarter of 1986, five quarters after M1 turned sharply up. It is possible that some of the growth in M1-A simply reflects more lax management of cash balances by individuals and companies as a result of the fall in interest rates.

Table IV shows that contrary to conventional wisdom, foreigners are not holding a rising percentage of federal debt. Despite the large budget deficits of the 1980s, foreigners are holding a significantly smaller percentage of the Federal debt than in the late 1970s.

Table V and Chart III show that during the 1980s, the Federal Reserve has monetized a much smaller percent of the federal deficit than during the 1970s. The claim that we have had too much money creation is not obvious in view of declining Fed monetization (as a percent), declining foreign holdings (as a percent), declining inflation, and declining interest rates. The claim could nevertheless be true, but I would want to see more signs of loose money before I tightened monetary policy.

Mr. Chairman, members of the Committee, I am not a monetarist, but I do believe that money matters. If monetary policy is going to be guided by money targets, they had better be the right targets, and the Fed had better hit them. Otherwise, the government's economic goals and deficit targets are not going to be met. So far in the 1980s, the Federal Reserve has largely countermanded the Reagan Administration's supply-side policy. The benefit of the Fed calling the shots was a more rapid than intended deceleration of inflation. The costs are the large budget and trade deficits and the severe debt crisis that stretches from the American farm community to the Third World.

The breakdown in the monetarist relationships upon which the monetary targets are based may only be temporary (see Chart IV). However, in view of the doubts about M1 and the actual conditions

in the world economy, the Fed had best watch, for a time at least, a broader range of indicators than monetary aggregates provide. The behavior of commodity prices, the real growth rate of the economy, sectoral strengths and weaknesses, consumer behavior, business confidence and investment, the growth of the world economy, all bear close watching. Without many signs of real strength, it could be a disastrous mistake to tighten monetary policy on the basis of M1 growth and speculation in the exchange markets that the Treasury wants a lower dollar.

That completes my testimony, Mr. Chairman. I request that my testimony together with its charts and tables and the two attached articles from the Wall Street Journal (October 28, 1986) and the Los Angeles Times (January 27, 1987) be included in the record.

TABLE I

Comparison of Original Nominal GNP Assumptions With Actual Developments

	Calendar Year					
	1981	1982	1983	1984	1985	1986
	(percent change)					
Original Assumptions						
Nominal GNP	11.1	12.8	12.4	10.8	9.8	9.3
Real GNP	1.1	4.2	5.0	4.5	4.2	4.2
GNP Deflator	9.9	8.3	7.0	6.0	5.4	4.9
Actual Developments						
Nominal GNP	11.7	3.7	7.6	10.5	6.2	5.3
Real GNP	1.9	-2.5	3.6	6.4	2.7	2.5
GNP Deflator	9.7	6.4	3.9	3.8	3.3	2.7

TABLE II

IMPACT ON BUDGET DEFICIT OF UNEXPECTED COLLAPSE IN NOMINAL GNP ($Bil.)

	Fiscal Year						
	1981	1982	1983	1984	1985	1986	TOTAL
Impact on receipts of lower than forecasted nominal GNP							
Nominal GNP with projected growth of March 1981	2958.4	3319.8	3742.4	4160.6	4574.5	5005.4	
Actual Nominal GNP	2986.4	3139.1	3321.9	3686.8	3937.2	4161.3	
Difference	28.0	-180.7	-420.5	-473.8	-637.3	-842.1	-2526.4
Receipts effect*	6.2	-39.8	-92.5	-104.2	-140.2	-185.3	-555.8
Impact on outlays of lower than forecasted inflation							
GNP deflator with projected inflation of March 1981	92.1	100.1	107.4	114.0	120.3	126.3	
Actual GNP deflator	92.1	98.8	102.9	106.9	110.6	113.9	
Percent difference	.0	-1.3	-4.1	-6.2	-8.0	-9.9	
Outlays subject to inflation adjustment	452.9	508.0	531.9	587.7	640.6	670.6	
Outlay effect	.0	-6.7	-22.9	-39.1	-56.1	-73.4	-198.2
Impact on outlays of higher than forecasted unemployment rate							
Total Unemployment Rate							
Projected	7.8	7.4	6.8	6.4	6.1	5.7	
Actual	7.3	9.0	10.0	7.7	7.1	6.9	
Difference	-0.5	1.6	3.2	1.3	1.0	1.2	
Outlay effect	-2.2	7.6	17.2	6.1	4.5	5.3	+38.5
Debt service costs associated with the above							
3-mo. bill rate (actual)	14.5	11.7	8.4	9.5	7.9	6.4	
Debt service on direct deficit effect	-0.6	1.4	6.4	14.7	18.5	21.6	+62.0
Total Deficit Effect	-9.0	42.1	91.2	85.9	107.1	138.8	+458.1

*Marginal tax rate of 22 percent

NOTES ON TABLES I AND II

- The national income and product accounts have been rebenchmarked since the time of the original Reagan Administration economic path of March 1981. The rebenchmarked series includes expanded imputations for the underground economy. Thus, it is not possible to compare levels of nominal GNP forecasted in March 1981 with the levels that actually materialized. A nominal GNP series consistent with the 1981 forecast was constructed by moving forward the actual FY-1980 nominal GNP now carried in the accounts by the forecasted rates of increase. This series was then compared with the actual series now being carried.

- Differences between these "projected" and actual levels of GNP were multiplied by an assumed marginal tax rate of 22 percent to obtain an estimate of the receipts effect of the shortfall from the original path.

- The lower inflation than was originally forecasted implies that outlays would have been substantially higher if the original forecast had been met. A forecasted deflator series was constructed by the same method as used in constructing nominal GNP consistent with the March 1981 scenario, and the differentials in levels of the deflator were applied to actual outlays to derive an estimate of the amounts by which outlays would have been higher under the original inflation assumptions. The reduced outlay effect of lower than forecasted inflation was calculated for those outlays directly affected by inflation by law or default: (1) indexed programs; (2) health care costs (Medicare, Medicaid, VA health care); (3) employee compensation, which typically moves with inflation, though with some lag; and (4) interest costs. Altogether, these represent about two-thirds of total outlays.

  In periods of unanticipated disinflation, higher real spending than intended occurs as a result of inflation falling below the amount budgeted. In the case of programs not directly tied to inflation, there is no automatic adjustment for the overshooting. To show how overspending can be built into the base of non-indexed programs, a factor for the differential between actual inflation and what was anticipated was applied to the one-third of the budget not directly tied to inflation.

  As a proxy for Congressional anticipations, we can use the CBO forecast of the GNP deflator made at the time of the budget submission for the fiscal year in question (e.g., for FY-1986, the CBO inflation forecast as of February 1985, which covers a span of the two years 1985 and 1986). Assuming the overshoot for any one year enters into the spending base for the next year, the figures can be cumulated.

Calculation of Spending Overshoot Resulting From Lower than Anticipated Inflation

	Fiscal Year						
	1981	1982	1983	1984	1985	1986	
Noninflation adjusted outlays ($bil.)	225.3	237.7	274.4	264.0	305.7	319.2	
CBO inflation forecast over two years (%)	19.0	20.4	15.4	9.5	9.8	7.3	
(annual rate)	(9.1)	(9.8)	(7.4)	(4.6)	(4.8)	(3.6)	
Actual inflation over two years (%)	19.7	18.0	11.8	8.3	7.5	6.5	
(annual rate)	(9.4)	(8.6)	(5.7)	(4.0)	(3.7)	(3.2)	
Inflation differential (percentage points)	-0.6	2.0	3.2	1.1	2.1	0.8	
Outlay impact ($bil.)	-1.3	4.8	8.8	2.9	6.5	2.4	
(cumulative)	--	3.5	12.3	15.2	21.7	24.1	76.8

- Calculations of the outlay effects of higher unemployment rates than contained in the original forecast are based on OMB rules of thumb.

- These calculations do not attempt to take into account the lags between the time of differences in nominal GNP and the impact of those differences on revenues or between the time of differences in price levels and their outlay impact. In actuality, lags exist in both cases.

- The calculations do not attempt to estimate the additional interest outlays due directly to the effect of the tight monetary policy on the real interest rate.

TABLE III

Quarterly Rates of Growth
(Percent, Seasonally Adjusted Compound Annual Rate)

Year/Quarter	M-1A*	M-1	M-2	M-3	Total Reserves
1980 - I	4.8	5.8	7.3	8.3	4.8
II	-4.8	-3.5	4.6	6.1	0.2
III	12.8	16.6	14.5	12.4	8.2
IV	7.6	11.4	9.6	11.5	13.5
1981 - I	-20.4	3.1	7.2	12.9	3.8
II	-5.0	9.1	11.0	12.2	9.3
III	-2.0	3.0	8.4	12.3	3.7
IV	0.6	5.5	10.5	12.0	0.4
1982 - I	2.3	8.9	9.8	10.8	4.8
II	-0.7	3.0	7.3	9.6	1.4
III	2.7	5.9	9.3	10.4	4.2
IV	10.1	17.7	10.1	9.2	15.0
1983 - I	4.5	11.6	22.2	11.6	5.2
II	6.3	12.8	11.4	9.8	13.3
III	6.6	10.3	7.3	8.6	5.8
IV	4.2	7.1	8.6	9.7	0.8
1984 - I	4.2	6.2	7.4	9.9	10.7
II	4.6	6.8	7.7	11.2	8.4
III	3.2	4.2	6.8	9.8	7.6
IV	2.6	4.5	10.0	10.9	4.3
1985 - I	6.3	10.5	12.2	10.6	19.2
II	7.5	10.9	6.5	5.6	12.4
III	11.3	15.3	9.9	7.8	16.7
IV	7.9	11.1	6.2	6.8	13.1
1986 - I	4.8	7.9	4.4	7.8	13.8
II	12.3	16.8	10.9	9.3	19.0
III	12.0	18.4	11.6	10.6	24.9
IV	11.2	18.3	9.5	7.8	23.3

*Demand deposits plus currency.

TABLE IV

Levels and Percent of Foreign Holdings of Gross Federal Debt
and Federal Debt Held by the Public

Year	Special Analysis E Series: Federal debt held by public* (bil.$)	Special Analysis E Series: Foreign international (bil.$)	Special Analysis E Series: Percent (%)	Domestic Finance Series: Gross Federal debt* (bil.$)	Domestic Finance Series: Foreign international (bil.$)	Domestic Finance Series: Percent (%)
1970	284.9	14.0	4.9	382.6	14.0	3.7
1971	304.3	31.8	10.5	409.5	31.8	7.8
1972	323.8	49.2	15.2	437.3	49.2	11.3
1973	343.0	59.4	17.3	468.4	59.4	12.7
1974	346.1	56.8	16.4	486.3	56.8	11.7
1975	396.9	66.0	16.6	544.1	66.0	12.1
1976	480.3	69.8	14.5	631.9	69.8	11.0
TQ	498.3	74.6	15.0	646.4	74.6	11.5
1977	551.8	95.5	17.3	709.1	95.5	13.5
1978	610.9	121.0	19.8	780.4	121.0	15.5
1979**	644.6	120.3	18.7	833.8	120.3	14.4
1980	715.1	121.7	17.0	914.3	121.7	13.3
1981	794.4	130.7	16.5	1,003.9	130.7	13.0
1982	929.4	140.6	15.1	1,147.0	140.6	12.3
1983	1,141.8	160.1	14.0	1,381.9	160.1	11.6
1984	1,312.6	175.5	13.4	1,576.7	175.5	11.1
1985	1,509.9	209.8	13.9	1,827.5	209.8	11.5
1986	1,714.0	256.3	15.0	2,112.0	256.3	12.1

* Federal debt held by the public equals gross Federal debt less holdings by Government agencies and Trust Funds.

** A benchmark revision as of December 1978 reduced the estimated foreign holdings of Federal debt. As a result, the data on foreign holdings for 1965-78 are not strictly comparable with the data for later years and the estimated "borrowing" from foreign residents in 1979 reflects the benchmark revision as well as transactions in Federal debt securities.

NOTES TO TABLE IV

The table shows the levels of public debt, foreign holdings of the debt, and the percent held by foreigners, using two concepts of the public debt: (1) Federal debt held by the public as published in Special Analysis E of the Budget, and (2) Gross Federal debt, as published in the Economic Report of the President. The basic source for both series is table FD-1 of the Treasury Bulletin. Both concepts include Federal debt held by the Federal Reserve. Foreign holdings of the public debt are from table OFS-2 of the Treasury Bulletin. Federal debt held by the public excludes government debt held by the government itself. Gross Federal Debt includes debt held by the Trust Funds and Federal agencies.

TABLE V

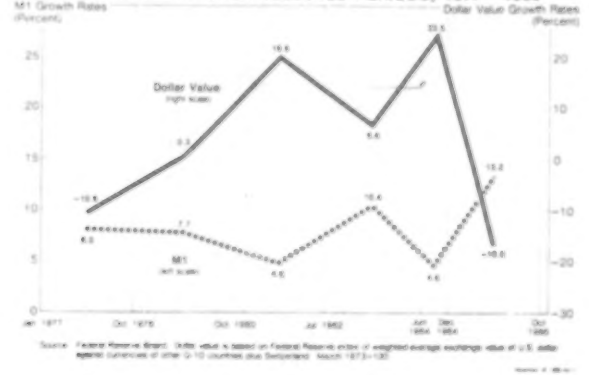
Federal Reserve Monetization as Percent of Federal Deficit
[Annual Data are Calendar Years]

	FEDERAL DEFICIT (col 1)	Change in FRB Holdings of GOV'T DEBT* (col 2)	Percent of Deficit Monetized [%(col 2/col 1)]
1970	$11.4 bil.	$4.2 bil.	36.9%
1971	24.8	7.5	30.3
1972	17.4	1.9	10.9
1973	7.5	0.6	189.0
1974	10.9	7.0	64.3
1975	75.4	5.4	7.2
1976	56.6	8.2	14.5
1977	51.8	7.6	14.9
1978	44.1	9.4	21.3
1979	28.1	9.0	32.0
1980	62.9	1.6	2.5
1981	78.4	9.9	12.6
1982	130.7	8.6	6.6
1983	190.4	14.0	7.4
1984	183.5	7.5	4.1
1985	215.6	19.0	8.8
1986	289.9	18.2	6.7
86:I	61.2	-3.9	-6.4
:II	38.5	7.9	25.9
:III	53.9	6.0	11.1
:IV	64.3	8.2	12.7

* U.S Government securities and Federal Agency obligations. Changes based on holdings for last month of each year for annual calculations, and on holdings for last month of quarter for quarterly calculations.

CHART I

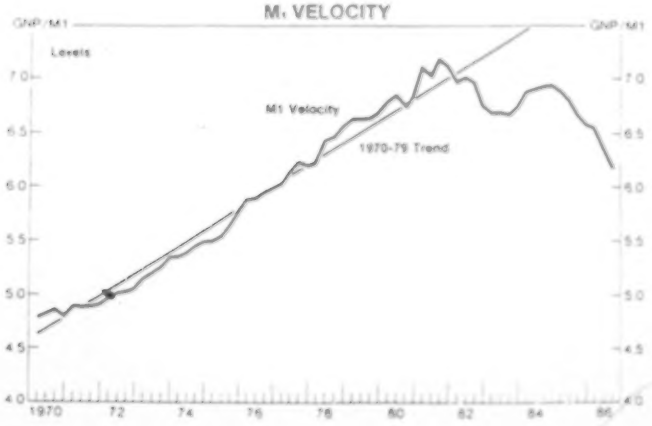
MONEY GROWTH RATES AND GROWTH RATES FOR THE VALUE OF THE DOLLAR OVER SELECTED PERIODS, 1977 — 1986



Source: Federal Reserve Board. Dollar value is based on Federal Reserve index of weighted-average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. March 1973=100.

Chart II

M1 VELOCITY



PROJECTION ON THE M'S

The CHAIRMAN. Thank you very much, Dr. Roberts.

I'm going to ask each of you to be king for a day and just give me a number in response to the first question and not any documentation of it or any additional comment on it.

M1 grew 16 percent last year. The question is this for each of you in turn starting with Mr. Axilrod: if you were Chairman of the Open Market Committee with six proxies in your pocket, what would you have established as the monetary growth for M1, M2, M3 for 1986, and what would you be planning for 1987, just the numbers?

Mr. AXILROD. Mr. Chairman, I would ignore M1 for 1986 and 1987.

The CHAIRMAN. All right. What about M2?

Mr. AXILROD. For M2, the 8.5 percent top of the range that they projected for 1987 strikes me as a tad high and I would have that at 8 percent.

The CHAIRMAN. M3?

Mr. AXILROD. Roughly the same, with margins of error.

The CHAIRMAN. All right. Dr. Chimerine.

Dr. CHIMERINE. Mr. Chairman, I would give exactly the same answer. I think M1 is irrelevant and I would target M2 and M3 in the current environment somewhere in the 8 to 9 percent range.

The CHAIRMAN. All right. Mr. Heinemann?

Mr. HEINEMANN. As I indicated in my statement, Mr. Chairman, I would target the monetary base—the Federal Reserve System's balance sheet. Growth in the base has accelerated approximately in the 10 to 12 percent area. My own personal preference would be to begin a systematic process of gradually reducing that growth. I would set a target for 1987 of between 7 and 8 percent.

The CHAIRMAN. For the monetary base?

Mr. HEINEMANN. For the monetary base.

The CHAIRMAN. You have no comment on M1, M2 or M3?

Mr. HEINEMANN. I would pass on M1. I think, as I indicated in my statement, that accelerations and decelerations in M2 and M3 are primarily a function of public portfolio decisions rather than monetary policy actions.

The CHAIRMAN. So as far as the base is concerned, you said that it was at what level in 1986?

Mr. HEINEMANN. As an order of magnitude, I think it's about 10 percent—a little higher than that.

The CHAIRMAN. And what would be your preferred level?

Mr. HEINEMANN. For 1986?

The CHAIRMAN. Yes, sir.

Mr. HEINEMANN. I wouldn't have allowed it to accelerate at all.

The CHAIRMAN. So there would be no increase in 1986, and 1987 would be what?

Mr. HEINEMANN. The question, as I understood it, sir, was what would I do from the present starting point.

The CHAIRMAN. No, that wasn't quite it. I want to know what you would have done in 1986 if you had been in charge, and then what would you do for 1987?

Mr. HEINEMANN. I see. For 1986, I would not have allowed an acceleration and for 1987 I would have aimed for a moderate reduction in that growth rate from the level that would have been achieved in 1986.

The CHAIRMAN. Thank you. Dr. Meltzer.

Dr. MELTZER. Senator Proxmire, we long ago at the Shadow Open Market Committee gave up on the aggregates for M1 because of the various shifts that have occurred. We have shifted to the monetary base growth rate and so I will give my statement in terms of the monetary base growth rate.

In 1985, it was 8 percent. In 1986, it was 8.5 percent, accelerating at the end of the year to more than 12%. I would have not allowed the acceleration in 1986 and I would reduce the growth rate to 7 percent in 1987 on a path to return the economy toward stable prices and not be content with 3 to 5 percent inflation.

The CHAIRMAN. Thank you very much. Dr. Roberts.

Dr. ROBERTS. Mr. Chairman, I don't quite know what's going on here, but I find myself agreeing with Mr. Axilrod and Mr. Chimerine.

Dr. CHIMERINE. Can I retract my answer and change it?

[Laughter.]

Dr. ROBERTS. I would add to that that I would watch other things other than money, which I believe the Federal Reserve Board is doing. They are forced off of the strict adherence to watching the monetary aggregates, not just because of the behavior of M1 but the monetary aggregates don't seem to—what you would expect from those growth rates don't seem to be manifest in the economy. So the Fed is watching a broad range of other factors which I believe they will have to continue to do.

The CHAIRMAN. Thank you, sir.

EFFECT OF MONEY GROWTH ON THE STOCK MARKETS

Mr. Heinemann, I would like to ask you about the connection, if any, and the extent to which there is a connection between the recent rapid money growth and the behavior of the financial markets, particularly the stock markets.

As we all know, there's been an enormous bull market going on all of last year and it accelerated this year. Yesterday it went up the biggest rise in history—not the biggest percentage rise by any means, but a big rise, 54 points on the Dow Jones in one day.

The question is, is there a relation between recent money growth and the financial market behavior? Particularly, is there a money growth effect on the stock market that explains the recent record increases?

Mr. HEINEMANN. In my judgment, Mr. Chairman, there is. In my statement I suggest that the extreme rate of liquidity creation has played a major role in fomenting the speculative atmosphere in the stock market.

From my own work in the market from day to day, my regular daily contact with institutional investors, it seems to me that the liquidity effect on stock prices is very powerful. To me, the behavior of the stock market is one of the important signals that we are now beginning to see a shift in price expectations in this country.

I find it difficult to believe that we will have an increase in unit volume in the economy which would generate a rise in profitability sufficient to justify the rise in stock prices.

I think what the market is telling us, in effect, that investors expect—let's put it politely—some pricing flexibility. In other words, wider profit margins in nominal terms. Inflation is on the way and this will help justify the kind of aggressive bidding for equities which we have seen in the recent past.

The CHAIRMAN. Thank you very much. My time is up.

Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman. I consider it quite an honor to attend my first meeting with such a distinguished group of economists, particularly those who are using only one hand instead of the "on the one hand and on the other hand" solution, and it is very reassuring to hear such widespread agreement.

There are a couple things that I would like to address that are slightly off the topic of your discussions today. Mr. Axilrod, for example, one of the concerns that's been expressed to some of us by those who oppose loosening of the restrictions on activities for banks is that if we allow banks to get into underwriting of government securities, et cetera, that it will limit the ability of the Federal Reserve to influence monetary policy directly.

To what degree should we be concerned about that?

Mr. AXILROD. Well, Senator, if you let banks get into the underwriting of state and local revenue bonds or corporate securities, I don't see that that will have any basic effect on the ability of the Fed to implement monetary policy, which goes through the reserve base, goes through some short-term markets, and indirectly through——

The CHAIRMAN. Mr. Axilrod, would you pull the microphone a little closer? It's a little hard to hear.

Mr. AXILROD. My response was I don't think permitting banks—if you had decided to do that and I'm not addressing that issue—to underwrite additional securities will have any effect on the Fed's ability to implement monetary policy, which goes through a whole other route.

The only conceivable adverse effect on monetary policy is if expanding the securities powers of banks leads to a weakening the structure of the banking system and if that makes the Fed reluctant to undertake the degree of tightening, for example, that might be needed under certain situations. But if you went the route of permitting banks to underwrite more securities, I assume you would do it in a way that would safeguard the core payments mechanism of the banking system relative to those banking affiliates which might be engaged in such underwriting.

Senator BOND. Thank you, sir.

I might ask Dr. Roberts, in addition to your suggestions that a looser monetary policy might assist with problems in the farm economy and in the Third World debtor nations, are there other remedies which you feel should be at least sought or implemented by the Federal Government to deal with those problems?

Dr. ROBERTS. First, let me say that I'm not sure that I recommended a looser policy. I was just giving many cautions against interpreting the current policy as loose and tightening it.

As for your question, yes, there are many things you can do and I think Professor Meltzer described them and I would agree with him wholeheartedly—his entire litany of steps that we need to take to focus on being a productive economy and it's very difficult to make up with monetary policy for problems which have other causes, and I think Professor Meltzer gave a thorough litany of what those problems were and I associate myself with most of his suggestions.

Senator BOND. Thank you, sir.

Professor Meltzer, you indicated that we cannot continue to lend to Third World debtor nations without increasing our debt. So what would you do for the debt problems in the Third World?

STOP LENDING TO OTHER COUNTRIES

Dr. MELTZER. I'm glad you asked that, Senator. I think for 4 years now I've advocated a policy which, if it had been implemented in 1982 or 1983, would have put the debt problem behind us to a much greater extent.

There are three basic steps. First, the United States should stop lending to other countries. It should request them to exchange debt for equity. They have assets that they can sell. If we continue to lend to them, we sell our assets to other people so that we can lend money to them. That doesn't seem to me to be a sensible policy for the United States. We are no longer a creditor nation. We are a debtor nation now.

So the first step is we to encourage them to exchange debt for equity.

Many of the governments are very concerned about of patrimony. As a second step, we should encourage them to adopt policies that will repatriate their own capital so they will sell assets and equity to their own citizens.

Now that isn't just a hope. We have experience with Chile and now with Mexico. We have seen that that policy can work if the local government wishes to make it work.

The third step that I have urged in the past and would urge now is that exchanges of debt for equity be made at the market value of the debt. This Committee could assist a great deal if it would tell the banks that when they make those exchanges they don't have to mark all the rest of their portfolio to market. That would encourage some steps in that direction.

But the committee could also work to encourage that policy by leaning very hard on the regultors to see that that becomes the policy of the United States Government.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

In some of your testimony I think several of you touched on the accommodative growth of the Fed as far as the monetary policy is concerned, some of it being judged prudent to now. But how much

longer can we go on in an accommodative stance—that is, there's a lot of money out there and the stock market some people think is an example of it now—before inflation really turns the corner on us?

Mr. CHIMERINE. Can I take a crack at that, Senator?

Senator SHELBY. Yes, sir.

Mr. CHIMERINE. I don't think anybody can give you a precise answer. It's a matter of evaluating the relative risks and right now, in my view, the risks of a higher interest rate led downturn in the U.S. economy, perhaps spreading to the rest of the world, is so large, and so far exceeds the risks of some more inflation, that I think slowing money growth dramatically is premature at best.

I wish I could tell you the exact time when we will be able to do that, but I can't. And, of course, the problem has been made more difficult by large budget deficits because the Federal Reserve is going to be under constant pressure to be accommodative in order to finance these deficits until they are reduced—not only because of the direct pressure on credit markets, but as you know, now that interest expense has become such a large item in the Federal budget, higher interest rates are just going to make future deficits even worse if they come about.

So to answer your question, I can't give you an exact answer, but I think we are not at that point yet.

Senator SHELBY. And does that also go because of the international debt situation?

CONSUMER DEBT

Mr. CHIMERINE. Yes. Not only the international debt situation, but even the domestic debt situation. I'm not sure whether it was touched upon before.

Senator SHELBY. Consumer debt?

Mr. CHIMERINE. Yes. We've had good growth in domestic demand in this country in recent years, but a lot of it has been financed by debt. However, demand is slowing dramatically. There is evidence that the high-debt burden is causing that slowdown, on top of stagnant real income growth and so forth. And higher interest rates would aggravate these problems and could dramatically slow the economy further, in my judgment.

Senator SHELBY. Your look at things as you're discussing now, as I read you, then the economy is not doing nearly as well as a lot of people say it is, if you look at the underpinnings of it?

Mr. CHIMERINE. I agree completely. I think the underlying fundamentals are mixed at best and, in fact, there is more reason to be concerned about the long-term health of the U.S. economy now than there probably has been in a number of years. Quite frankly, as I think most of us said here earlier, the conditions which existed 20 and 30 years ago which permitted us to significantly improve living standards in this country no longer exist.

Second, we've borrowed from the future by going deeper and deeper into debt and we can't keep doing that.

Third, these large budget deficits have now become counterproductive. All of their factors are going to limit economic growth in the future and if monetary policy is tightened, and aggravates

those problems, we could have a very, very serious economic downturn.

Dr. MELTZER. Senator Shelby, may I respond to that also?

Senator SHELBY. Yes, sir.

Dr. MELTZER. I would like to give a different answer. First, The long record of experience is that we cannot prevent a recession by faster money growth. What we can do is postpone recessions, only to create a bigger recessions later. That's what we did in the 1970's. We printed money faster. We postponed the recession. We had a really ripsnorting recession because we had a high rate of inflation that the public wanted to end.

So the question is not, can you prevent recessions? The answer to that is, no, you cannot prevent them. You may be able to postpone one temporarily.

Second, I would like to ask: What are people betting on? The whole policy of this administration and the Federal Reserve is to devalue the dollar. That policy can only work by raising prices of imported goods relative to wages. If it raises wages as fast as it raises prices, then the policy will fail. All we will get is a nominal devaluation. We will not get a permanent solution to our trade problem.

Our policy can only work by raising prices. I believe that there are better policies available, as I've said.

Mr. HEINEMANN. Senator, the inflation rate as currently reported is very low and many people believe that inflation will continue to be very low. However, I think there are numerous signs of incipient price pressures, including most particularly the sharp increase in prices of imported products other than oil.

I think quite apart from what expectations are in this country, foreign investors who are the critical suppliers of funds to the U.S. economy now, are concerned about the inflationary potential in U.S. monetary policy. They are becoming increasingly reluctant to lend us money at prices we can afford to pay.

We are holding down the short-term interest rate at the present time, but only at the cost of a progressive acceleration in money growth. We are putting more and more money in. We're like a drug addict. We have to have a bigger fix every time in order to satisfy ourselves.

Senator SHELBY. Dr. Roberts, did you want to comment?

Dr. ROBERTS. Yes, Senator. I want to address this question about stock market behavior of foreigners.

I believe it's correct that foreign buying of U.S. equities or stocks is now at an all-time high. It has been accelerating since the second quarter of 1985. Prior to the weakening of the dollar, foreigners were net sellers of stocks. As the dollar has weakened, their purchases of U.S. equities have reached an all-time high.

I think this is one of the reasons for the stock market's performance. Another I think is since about 1984, you have had over $200 billion of equities disappear off the market due to leveraged buyouts, mergers and repurchases, and a third factor that's driving the market I think is the tax reform.

As I testified at the time, one powerful impact of the tax reform that I was concerned about was to give a windfall gain to all exist-

ing capital. When you cut the tax rates across the board, you give a windfall gain to the existing capital stock.

What you see going on is the stock market repricing assets to reflect that windfall gain.

I think in view of these three factors it would be dangerous to assume that the rise in the stock market is a reflection of the Fed pumping out huge quantities of money.

I wouldn't want to deny that the Fed pumping out money could cause the stock market to go up, but I think here we have three very clearcut real factors that are causing the stock market to rise.

Senator SHELBY. My time is up. Mr. Chairman, thank you.

The CHAIRMAN. Mr. Axilrod didn't get a chance to respond to your last question.

Senator SHELBY. I would like for him to respond. I appreciate the chairman's indulgence.

Mr. AXILROD. Thank you, Mr. Chairman.

I think if you evaluate the monetary aggregates, you certainly shouldn't evaluate them in isolation. In the 1970's, when the monetary aggregates were contributing to inflation, much of that inflation starting in a way from oil price increases, but the monetary aggregates contributed and helped sustain it. You will also find that at the time the level of real interest rates was close to zero. That is, the nominal short-term interest rate and the rate of inflation were moving together. There were no real costs to stop people from borrowing.

In the 1980's, we've had a very sharp growth in the monetary aggregates. I suspect in terms of M1, much more than in the 1970's. The reason that hasn't contributed to inflation—there are a lot of reasons, but one very good reason—is that the level of real short-term interest rates has been relatively high. Because of that, I would not call Federal Reserve policy totally accommodative. It has been accommodative, but I think there has been a residual degree of restraint in that policy and that residual degree of restraint has kept the rate of inflation from accelerating and has kept the unemployment rate in this country above what we like to think as normal.

Still, there hasn't been enough restraint to get the inflation rate down further.

Senator SHELBY. It's been balanced up to now, but will it stay that way?

Mr. AXILROD. Well, no one can really foretell the future with great certainty. The only obvious source of inflation at the moment is the drop in the dollar, and that will become more obvious if there's a very sharp drop in the dollar.

The budget deficit looks like it's coming under control. If the people are disappointed in that, that would be another factor causing a change in inflation expectations.

Thus far, unit labor costs in our industry have been held down. It was only a 2.25-percent increase last year, so it was very low. If that is sustained, we have relatively little reason to fear a burst of inflation except out of a sharp drop in the dollar, unless the oil cartel has got a lot more power in it than I think.

Senator SHELBY. Thank you.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Dr. Meltzer, you were listing three steps that you felt we should take in order to deal with the Third World debt. The last of those related to pricing the trade of debt for equity at market rates.

Could you elaborate on that and what specific policies you would see as necessary in order to accomplish that?

Dr. MELTZER. Well, the debt is being traded. There is a secondary market. It's not a very strong market, but from inquiries among people who are making these transactions, in the banks and so on, even quite sizable transactions are made not far from the quoted prices.

To give an example, Mexican debt sells in the marketplace at about 60 cents or 65 cents on the dollar, depending upon what the prospects are. Brazilian debt was selling for somewhat higher until very recently when it may have fallen. Argentina would sell somewhere like Mexico.

A person who wants to invest in Mexico—for example, suppose a Mexican citizen who has sent his capital to the United States and has it invested in the United States market or in some foreign market, would like to repatriate part now. He goes to a bank and buys back the debt at the market price of the debt, brings it into Mexico and gets something close to the full face value in exchange. He makes a very large gain which gives him a great incentive to repatriate some of his capital.

What the transaction achieves is to reduce the debt from the $100 billion range, in the case of Mexico or Brazil, and gradually reduces the outstanding amount.

It's my estimate—a conservative estimate I believe— that if we did something on the order of 2 to 3 percent of the debt in swaps every year we could have that problem manageable at the end of 5 to 6 years, with a little bit of good fortune.

What needs to be done? One of the things—by no means the only one—one of the things which inhibits those transactions is that under the current regulations banks believe that they have to mark to market all of the debt on their books and report the losses. Since they sell the debt at 60 cents on the dollar, they might have to report a loss of 40 percent of their debt on all of their holdings if they in fact made that transaction.

So a lot of the transactions are being made not by using U.S. banking-owned debt but buying debt from, say, Arab banks or Third World banks and exchanging those debts for equity. I think we would be well advised to consider the policy of trying to not have mark to market all of those debts to encourage and facilitate this exchange of debt for equity.

The other thing that we need to do is that we need to lean on the U.S. Government to push a policy of exchanges as an alternative to increases in World Bank quotas or increases in IMF quotas and more lending. What we need to do is encourage our Government to get out of the lending business, stop lending U.S. dollars to those countries, to encourage them to solve that problem through the marketplace in the way in which I have suggested.

Senator GRAHAM. Dr. Roberts, you referred to the importance of the expanding world economy as one of the keys to dealing with the concerns that you had outlined.

What would be your comments on Dr. Meltzer's proposal as it relates to a means of handling Third World debt and the impact of that accommodation on general world economic expansion?

Dr. ROBERTS. I think, Senator, that it's clear that it would certainly help because it's very difficult for these countries to import when they can't service their debt. So I think to sell it at its market value is a good idea. It may put some hardship on the banks, but I generally favor and have proposed the same type of solution as Professor Meltzer.

I think it might also help if some of the G-5 trading partners also look to the world growth rate and be sure they don't act in ways that would curtail it. If our trading partners are too tight in their exercise of policy, then we can't hardly make up the whole difference.

Senator GRAHAM. No further questions.

The CHAIRMAN. Mr. Heinemann, I am concerned about the synergy here, the combination of expansive fiscal policy and expansive monetary policy. We have been discussing so far primarily expansive monetary policy. It seems to me that they work together and, together, they create a situation which in spite of the very thorough and able way that Mr. Chimerine described the deflationary aspects in the economy or the antiinflationary aspects, that here is something that over time and over a relatively short time is likely to give us a tremendous inflation—worse than many people have expected or talked about our having.

Plus the fact, there's one other element you may want to comment on, and that is the monetary policy contributes to the deficit in quite a different way than I think Dr. Roberts and Mr. Chimerine described it in my view.

What monetary policy has done is to hold down interest rates temporarily in the short run and, therefore, put less pressure on the Congress and the administration to take the kind of action that we should take to cut the deficit.

What's your reaction to those two observations?

INFLATIONARY POTENTIAL MONETARY POLICY

Mr. HEINEMANN. Senator, I have tried to emphasize in my statement and in my oral remarks the concern I have about the inflationary potential in current monetary policy.

I wonder if we will actually reach the point, though, of seeing a runaway reacceleration of inflation in the near future. I do doubt that. I think a substantially faster rate of change in prices is likely, but a runaway inflation in the near future I think is improbable for a whole host of reasons, many of them technical.

But most importantly, I suspect that the process of progressive acceleration in money growth which is going on will bring the process to an end a lot sooner than we may now expect. Foreign investors have concerns about what we're doing in our monetary policy.

Beneath the 'Twin Towers of Debt'

By Paul Craig Roberts

It is high fashion to attribute the U.S. budget and trade deficits to the 1981 tax-reduction act. This idea, beaten into the public's consciousness by constant repetition, is incorrect and dangerously misleading. Yet this misinformation survives a free press and freely available statistics.

In recent editorials, the New York Times, the Washington Post, and New Republic saw "the twin towers of debt" built thus: Huge budget deficits from the loss of revenues brought high interest rates. Lured by high interest rates, foreign money jolted into the U.S., pushing up the dollar and causing the trade deficit. The deficits failed to cause the inflation that the Times and the Post had predicted "because they were financed by borrowing from abroad."

Now comes economist David D. Hale in the Heritage Foundation's latest Policy Review to misinterpret the U.S. budget deficit as "a highly expansionary fiscal policy since 1981" and ask whether the "first experiment in global Keynesianism" was leading to world depression.

Capital Inflows Fell

Notice the chronology of the explanation: Tax cuts led to budget deficits, which led to high interest rates, which led to an inflow of foreign capital, which drove up the dollar, which gave us the trade deficit. Now compare this chronology with the facts in the U.S. Capital account (see table).

Note that between 1982 and 1983, when the net identified capital inflow shifted from negative to positive, *capital inflows into the U.S. actually fell by $9 billion.* The change in the capital account resulted from a $71 billion fall in U.S. capital outflows, not from an increase in capital inflows. And over the 1982-84 period—the time when the story of massive foreign money pouring into the U.S. from abroad was firmly fixed in the country's consciousness by Federal Reserve chairman Paul A. Volcker, Council of Economic Advisers chairman Martin Feldstein, budget director David A. Stockman and their echoes on Wall Street and in the media—there was no significant change in inflows of capital into the U.S., but capital outflows collapsed from $121 billion to $24 billion, a decline of 80%. Inflows indeed have risen since, but the outflow decline is clearly the origin of the large trade deficit, which by definition is a mirror image of the capital surplus.

What caused the collapse in U.S. capital outflows? A case can be made that the short-lived business tax cut in 1981 and the reductions in personal-income-tax rates in mid-1982 and mid-1983 raised the after-tax rate of return on real investment in the U.S. relative to the rest of the world. Therefore, instead of going abroad, the money stayed home and invested in equipment and structures. In this case, the dollar rose from its historic lows of 1978-80 because the tax cuts improved the investment climate in the U.S., and capital exports dried up. As a supply-sider I am sympathetic to this case. However, a stronger force than tax cuts was operating on U.S. capital outflows.

U.S. Capital Account, 1980-85

(In billions of dollars)

	1980	1981	1982	1983	1984	1985
Capital inflow to U.S.	$ 58	$ 83	$ 94	$ 83	$103	$127
Less capital outflow from U.S.	86	111	121	50	24	32
Equals net identified capital inflow	-23	-28	-27	35	79	96
Plus statistical discrepancy & other (inflows)	26	21	36	11	27	23
Equals net capital inflow to U.S.	$ -2	$ -6	$ 9	$ 47	$107	$119

NOTE: Components may not add due to rounding

Source: Commerce Department

That force was the unexpected collapse in the U.S. inflation rate between 1980 and 1982. This collapse caused a fundamental change in the lending practices of U.S. banks. Money-center banks were heavy lenders to the Third World, expecting rising commodity prices, such as oil and copper, to service and repay loans. When inflation unexpectedly collapsed, the banks realized that they had overexposed their capital and stopped lending. This change in behavior is the primary reason U.S. capital outflows dried up. In other words, the U.S. has a trade deficit and became a net capital importer because U.S. inflation fell far below anyone's forecast.

This calls for another look at how the Reagan administration's inflation forecast compares with what actually materialized. It is instructive to remember that when the forecast was released in 1981, it was harshly criticized as dishonest for predicting falling inflation in the face of "inflationary tax cuts." No one expected that actual inflation would come in far below the administration's forecast—least of all the readers of the New York Times and Washington Post editorial pages. Yet the consumer price index tells the story: for 1981, a forecast of 11% vs. 8.9% actual rate; for 1982, 8.2% vs. 3.9%; for 1983, 6.2% vs. 3.8%; and for 1984, 5.4% vs. 4.0%. (The CPI has continued to run below the target since.)

On Page 399 of his book, "The Triumph of Politics," David Stockman shows that this unexpected disinflation, together with the severe recession that it caused, is the source of the U.S. budget deficit. Over the 1982-86 period, nominal gross national product was $2.145 trillion below forecast. Since budgets are prepared in nominal terms, the unexpected disinflation not only cost the Treasury revenues, it wiped out spending cuts Mr. Stockman thought he had achieved, transforming the nominal cuts into increases in real government spending. Curiously, Mr. Stockman's words do not make the same argument as his facts. After showing the quantitative impact on the tax base of the unexpected disinflation, he blames the budget deficit on the 1981 tax cut.

The explanation that attributes the twins towers of debt to the 1981 tax cut breaks down in its other linkages as well. For example, high interest rates and the dollar's rise in value *preceded* the large deficits and the tax cuts. The dollar snapped back in 1981 when its trade-weighted value rose 19% over its 1980 level, the largest single-year gain in the dollar's rise. That year the budget deficit rose only $5.1 billion to $78.9 billion from $73.8 billion in 1980.

An inverted yield curve, with short-term rates above long-term rates, characterized the economy in 1979, 1980 and 1981. The inverted-yield curve is an unmistakable sign that high interest rates were caused by stringent monetary policy. The federal-funds rate, an overnight rate set by the Fed, was higher than the interest rate on long term triple-A corporate bonds from October 1978 to May 1980, from October 1980 to October 1981, and from March 1982 to June 1982. In April 1980 the federal funds rate exceeded the corporate bond rate by 5.57 percentage points and in December 1980 by 5.69 percentage points. In January 1981, when Mr. Reagan was inaugurated, the gap peaked at 6.27 percentage points. Overall, interest rates peaked in 1981 with the budget deficit unchanged from its previous year's level. The budget deficit appears to have peaked in 1986 at three times the size of the 1981 deficit, with the federal funds rate only one-third as high as it was in 1981.

Depending on Luck

Far from being an expansionary fiscal policy, the U.S. budget deficit is a sign of unexpected disinflation. The few people who have tried to establish the facts have been misinterpreted and derided as saying that "deficits don't matter." Their argument is different. They are saying that without a pro-growth policy, debt cannot be serviced or reduced, narrowing the prospects for the world economy to a choice of deflation or reflation.

People can disagree on how we should get out of our difficulties, but if they do not understand how we got into them, a solution will depend entirely on luck. Economic policy making is hopeless if facts cannot penetrate public discourse.

Mr. Roberts, an early Reagan Treasury official, holds the Simon chair in political economy at Georgetown's Center for Strategic and International Studies.

Bank reserve growth averaged 10.6 percent in 1984, 13.6 in 1985, 20.4 last year. It was much faster than that at the end of the year. These are average month-to-month changes.

As I indicated, in the last few months, reserve growth has been running over 30 percent in the context of slight increases in short-term rates.

It strikes me this is a process which is starting to run out of control. I do strongly believe that rates are being held down through progressive injections of liquidity. I am concerned that this boom in money growth, which will come to an end like all booms—it's a spike up and it will come down just the same way—when that happens, if it comes down from a very high level, we can have very serious real shock effects on the economy.

I don't think we are going to get a major new inflation in the immediate future, but the potential is there and financial markets are already giving us fair warning that the time we have left to correct policies is limited.

For an equally large number of reasons, I feel that we have made a fundamental political mistake in being unwilling to impose sufficient explicit taxes to pay for the Government services that we want to consume. I think it's very hard for taxpayers to decide how big they want the Government to be if they don't really understand currently how much it's going to cost.

I don't view the fiscal policy actions of last year as a net tax reduction. We shifted the incidence of explicit taxation from the individual to the corporation. I don't quite understand how that leads to a revaluation of corporate assets. It does seem to me that the total tax burden that the economy will have to bear over time has gone up because Government is bigger today than it was at earlier times.

Adjusted for the stage in the business cycle, Federal spending is about 2 percentage points higher today than it was in the last business cycle at a comparable point. Government is much bigger today than it used to be and, therefore, the total explicit and implicit real tax burden is higher—not lower.

I think that it will be difficult to get a political consensus on reducing the size of Government, assuming that's what we want to do, until we really understand what government costs.

The CHAIRMAN. Thank you very much, Mr. Heinemann.

I should have announced when I started, but since there are three of us questioning now we will go to a 10-minute questioning period and that leaves me with about 6 minutes.

Now, Mr. Axilrod, are you comfortable with a 23-percent increase in monetary reserves, the base reported by Mr. Heinemann; and as one of the world's leading monetary policy experts, can you tell us unambiguously that we should not be concerned about inflation?

Mr. AXILROD. I am not uncomfortable with that 23 percent. To explain why, can I give you an example, if you'll bear with me for just a second, through a simplified example.

Suppose there were two assets in the world. One was a long-term bond and one was a deposit that bore interest and was subject to reserve requirements. Suppose at the beginning that deposit had a 5-percent interest rate and the long-term bond had a 10-percent in-

terest rate. Then most people would be investing their money in the bond.

But for one reason or another, suppose the yield on that bond dropped to 6 percent and the yield on the deposit dropped only to 4.5 percent, so that the spread became much narrower. Then a lot of people who don't like the risk of price fluctuations in the bond would say:

> Well, it's not worth my while to keep my money in that bond. I'll keep it in that deposit where I can get 4.5 percent and I'm not subject to big price risks.

Now to support the money that is shifted to deposits, since they are subject to reserve requirements, the Federal Reserve has got to provide the reserves. You might very well get a 23-percent expansion in reserves at that point. The expansion is merely to accommodate the public's desire to hold that money there.

That would be, in a way, a passive role for the Federal Reserve. The active role would be for the Federal Reserve, willy-nilly to push that 23-percent increase out. Then, of course, it would be forcing money on the public that they didn't want; as a result, the public would probably try to spend it, with inflationary potential.

So the answer to the question you raise depends on a judgment about whether the public does or does not want to hold the deposits supported by reserves as part of their longer run savings, and whether the Fed is being passive or active in adding to bank reserves.

I feel relatively comfortable that we have a more passive attitude on the part of the Federal Reserve in relation to M1 and currency, which is the main component of the base, and that it's not an inflation-creating attitude. I think it's not inconceivable we will have an inflation ahead, but I suspect if it comes it's going to come really from a drop in the dollar far beyond what the fundamentals call for and that is caused by loss of confidence.

The CHAIRMAN. You do that on the basis of the distinction between passive and willy-nilly?

Mr. AXILROD. Well, I'm trying to put it in terms that are readily understandable.

The CHAIRMAN. Dr. Meltzer.

Dr. MELTZER. I would say, Mr. Chairman, that one wants to be cautious about that argument. The argument that the Federal Reserve should meet the demand for money because people want to hold it is not very different—in fact, very similar—to the argument that was made by the German central bank in the 1920's when they bought additional printing presses because there was such a large demand for currency.

I don't see signs of a large increase in the demand for money in the United States.

I believe that the other interpretation, the more dangerous interpretation, is the more reasonable interpretation of current events. And I say that because what we have seen is two things which should warn us. One is that short-term interest rates, as Mr. Heinemann pointed out in his statement, have been rising despite massive money growth.

Second, we have seen a fairly substantial devaluation of the dollar in a relatively weak world economy. That is, not a weak U.S.

economy, but a weak world economy. That's a sign that a good part of that devaluation is very likely to be nominal, not real, and the result of too much money being produced.

Dr. CHIMERINE. Mr. Chairman, can I answer that?

The CHAIRMAN. Go right ahead, sir. I have a question for you, but go right ahead.

Dr. CHIMERINE. Why don't you ask your question and I'll try to address both together.

The CHAIRMAN. All right. On page 14 of your testimony you say:

> The corporate sector is especially more vulnerable to an economic slowdown, or higher interest rates, because it has not only been adding debt at record levels, but it has also been redeeming equity since 1984, making it more leveraged.

That's one reason you call on page 16 for a more accommodative monetary posture in the near term.

My question is, is the hostile takeover phenomenon, in your view, one of the reasons for the increasing corporate debt?

CORPORATE DEBT

Dr. CHIMERINE. Yes, without question, I think it has accounted for a sizable part of the increase in corporate debt, but there are other reasons corporate debt has risen as well.

The CHAIRMAN. Of course, there are, but is it substantial, and to the extent that there are——

Dr. CHIMERINE. It is a substantial part of the rise in corporate debt, but the point is is this, Mr. Chairman, it still has to be financed and a significant number of our clients, for example, are telling us that one of the reasons they are trimming their capital spending budgets is because of the increased difficulty they are having servicing that debt. So there are costs to it. It doesn't come free, and my concern is that it is going to work at the expense of near-term economic activity. And as I said earlier, I don't think the Fed can stimulate the economy very much, but my concern is, if they tighten on top of these factors, we have the chance of seeing a sizable downturn.

If I might quickly make quick reference to a few of your other comments. First of all, with respect to fiscal policy, well, I think you are well aware of my concerns regarding the federal deficit for many years. We are now paying a price for them. Nonetheless, as we cut these deficits, we are implementing somewhat restrictive fiscal policies in the near term.

So in the near term, it is a drag on the economy.

Second, as Steve Axilrod and I mentioned earlier, I haven't found too many farmers or steel companies or energy producers who think interest rates are low right now. For a large segment of the borrowing population, particularly, the manufacturing sector and the commodity producers, real interest rates are still very high. So, from that perspective, monetary policy has not been extremely loose and easy and inflationary, and when you have real interest rates at the levels we have had in recent years.

Third, if we had managed the economy based on the rapid growth in M1 in recent years, and tried to clamp down on M1 growth, as many people argued, we would be in a severe recession right now. You can't go back now and say, "Well, you're right, but

now let's focus on reserves, or on M2 or M3." I think some of the monetarists are doing exactly what they accuse the Federal Reserve of doing in this respect.

The truth of the matter is that the money numbers and the reserve numbers are distorted by enormous shifts in deposits, and by rising import penetration—the demand for credit is increased just as much from imports as from domestic purchases but they don't show up in domestic GNP and, therefore, the velocity declines. The M1 numbers are just not useful.

Finally, the correlation between M1 and inflation has been enormously overstated, even before the technical factors began impacting M1. The correlation is not anywhere near as close as some people suggest. The relationship depends on underlying conditions—such as enormous overcapacity, wage restraints, high unemployement, weak commodity prices. Thus, even with the weaker dollar, and while admittedly, we have to be concerned about the potential down the road, I don't see how anyone can make now, a valid argument for tightening significantly now, because we also have to be concerned about slow growth, high unemployment, LDC debt and all the other things we've talked about. And it is a matter of balance.

Last point, about the dollar. The dollar is coming down, because we have large and unsustainable trade deficits, and it is going to come down regardless of whether we tighten money growth or loosen money growth a little bit. The trade deficit is why the dollar is coming down, and it will continue to come down. As for the recent increase in interest rates, financial markets now play a guessing game with the Fed, and for a while the markets expected additional easing by the Fed. Recently, because of some recent strange statistics and because the dollar is coming down, they are questioning whether the Fed will ease, and as a result, interest rates have backed up a little bit.

I don't think you can attribute the small increase in short-term rates last week, to the fact that all of a sudden, the financial markets have gotten worried about the growth in M1.

Dr. MELTZER. But it isn't last week. It's over the last 6 months.

Dr. CHIMERINE. Oh, it is not over the last 6 months.

The CHAIRMAN. Mr. Chimerine, I vigorously disagree with you, but my time is up, and Senator Heinz now has 10 minutes.

Dr. CHIMERINE. Good. I'm glad. [Laughter.]

Senator HEINZ. I note from the almost, but not quite, unanimity of the panel [laughter] the age-old adage that if you took all the economists in the world and laid them end to end, they would not come to a conclusion is still true.

Mr. ROBERTS. They will come to a whole bunch of different ones.

Dr. CHIMERINE. That seems to be true of Congress, as well, these days.

Senator HEINZ. Different ones, yes.

I am particularly pleased to see that my two Pennsylvania constituents, Alan Meltzer and Lawrence Chimerine are still at opposite ends of the conclusion from time to time. You've got to make it interesting for us, but it is good to see you, even if you give me conflicting advice.

J-CURVE

I want to ask a question about the J-curve, about trade, and about the dollar. There are a lot of people, principally those in the administration, who are saying the dollar has softened, a few other currencies have strengthened, the mass of the currencies relative to the dollar has strengthened and just wait, the solution to the trade deficit problem is just around the corner. In their view, we haven't quite yet hit the bottom of the J, but as soon as we do, it is going to shoot right up into a big lovely capital letter like we want.

Is there any evidence that that is true? Who wants to take a crack at that?

Dr. CHIMERINE. Well, I will, Senator. I think the best we can say so far is that the trade deficit seems to have stabilized. It has been very erratic on a monthly basis, but if you take the laset 3, 4, or 5 months on average, it looks like it has peaked out when you measure it in nominal terms. If you look at it on a real basis, it looks as of the deficit has started to decline sharply.

We've got some anecdotal evidence in support of that. We have seen an increase in export in a number of industries, particularly chemicals, paper, some of the other industries that compete previously against Europe, where we have now become much more competitive, and where labor cost differentials aren't very important.

Senator HEINZ. You are something of a guarded optimist, that in fact, first, the J curve exists and second, we are somewhere down there.

Dr. CHIMERINE. Yes.

Senator HEINZ. But where you are guarded is that your not so sure that the J isn't lying on its side. [Laughter.]

Dr. CHIMERINE. No, where I am most guarded, Senator, is that I think the turnaround will be modest, partly of the J curve, partly because for other reasons. And second, that doesn't mean the economy will grow more rapidly. I think the improvement in the trade deficit will come at the expense of domestic demand.

Senator HEINZ. Does anybody either have a more pessimistic or more optimistic view?

NEED TO BE PATIENT

Mr. AXILROD. I have a view. I am not sure how you would describe it as pessimistic or optimistic. I think we are moving in the right direction. I think the worst thing that we could do is lose patience and seek a rapid solution to the trade problem, either through protectionism, which has very obvious structural difficulties or other attitudes. Those other attitudes could get reflected, if the world loses patience, or thinks we are losing patience, in a very sharp drop in the dollar. It could be sharp enough to get the trade deficit improving rapidly, but I think the other repercussions of that, the inflationary repercussions of that, the fact that a rapid improvement might come before our fiscal deficit is under control, would mean the great risk of inflation followed by recession.

So I believe the best thing we can have is a degree of patience. Thus far, the world is interested in putting its money in the United States, and I can see no reason why it shouldn't, unless they sense we are losing patience.

Dr. MELTZER. Senator, may I say one thing?

Senator HEINZ. Yes.

Dr. MELTZER. Incidentally, it is very good to see you again, sir.

I think we have to distinguish two things between real devaluation and nominal devaluation. Nominal devaluation may have some advantage to us short term, but it is the real devaluation that has to carry the ball to keep the trade problem under control for the long term. I am optimistic that the trade deficit has turned. I think we need to do considerably more to get us back to some kind of reasonable position, where we are not pouring out debt. And I believe what we need to do is much more to boost production in this country by productivity-enhancing measures and to reduce consumption.

Senator HEINZ. My question to you is this. How can the trade deficit ever do anything much more than stabilize, as long as most of the world's economies either are at or moving toward mercantilism? That is what we face in Latin American and the East Asian economies. And we all know what a mercantilist economy is. It is a one-way street.

Dr. CHIMERINE. Senator, I share your concern, and I think this is one of the reasons the turnaround will be modest. We are beginning to see sharp declines in investment in a number of countries, especially some of the large industrialized countries, because their export industries are experiencing a profit squeeze. And historically, capital goods have been our stronger export sector along with agricultural products. Furthermore, Mexico is still in terrible shape. It is very hard to export anything into Mexico, and now OPEC has been cutting back in their imports from the United States as well. This gets back to the issue of evaluating monetary policy in the insist of the underlying environment, because you are absolutely right, our ability to improve our trade deficit through faster export growth is being limited by weakness elsewhere.

That probably means that we are going to get more declines in the dollar, and higher import prices, because a larger fraction of the adjustment is going to have to come on the import side.

Dr. MELTZER. Senator, that leads us in the wrong direction. Whatever may be going on in the world, we are moving in the wrong direction, if we, in fact, joint them in a policy of mercantilism.

Senator HEINZ. Oh, I agree.

Dr. MELTZER. That is going to make the problem much harder for us.

Senator HEINZ. I don't think there is a lot of support, I hope, for mercantilism in the United States.

Dr. MELTZER. I hope that is right.

Senator HEINZ. I hope we are opposed to it, although it did wonders for us back in the 1890's. We were small, and, like other small countries are now, we could get away with it. In addition, it also built our steel industry.

Let me ask this, to bring this subject back to monetary policy and the Federal Reserve's policies.

At some point, a dollar that continues to drop creates, as we all know, inflationary pressures that become very powerful. How close are we to hitting that kind of sound barrier? How close are we

coming to the drop of the dollar that will reignite inflation? It certainly did do that back in 1977–78.

Dr. MELTZER. Too close. Too close. That policy can only work, Senator—the only way our policy can work is by raising prices relative to cost or production. That is what the policy of devaluation is. So it not possible to have one without the other.

Senator HEINZ. Let me, for the sake of argument, assume Alan Meltzer is right. We know he is right, but let's assume——

Dr. MELTZER. Thank you.

Senator HEINZ [continuing]. On his evaluation, that we are getting close to the inflation reignition point.

Let me ask Mr. Heinemann, who's been smart. He's been very quiet. Mr. Heinemann, if you were at the Federal Reserve, if you were czar of the Reserve, and you saw inflation igniting or if you saw us about to get there, what would you do? Would you tighten monetary policy? Would you loosen it? What would you do regarding interest rates?

Mr. HEINEMANN. One of my colleagues on the Shadow Open Market Committee and a former constituent of yours, Dr. Jerry Jordan, has promulgated one of the basic laws of economics. And Jordan's law is that the only way to prevent a hangover is not to get drunk. I think that is the only effective way to deal with the long-run inflation problem. We already see prices of imported products at the wholesale level, other than oil, rising more than 8 percent, the increase year on year in the year ended September 1986 was actually about 10¼ percent.

RISE ON IMPORT PRICES

I would anticipate we will get some further acceleration in prices of imported products. Imported products, as you know, constitute almost a third of the goods sector of the American economy. I believe that the policy that we are following will produce its intended result. As Dr. Meltzer said, this is a higher rate of domestic inflation in the United States. That is what the policy is designed to do.

As far as the J curve effects that you made reference to, I fully share your concerns about mercantilism in this country or anywhere else. In the very short run, we've got to remember that the dollar has been extraordinarily volatile. It went up sharply and has come down sharply. So I suspect we are seeing in the marketplace some echo effects of the past rise as well of the current decline.

My friend and colleague in New York, Larry Viet of Brown Brothers, Harriman, has observed that we have an overlapping J curve effect in the market today. The echo effects of the previous overvaluation probably still influence the data. When you look at the trade data in real terms and exclude oil—which, of course, is a dollar-quoted commodity and would not be expected to respond in the short run to changes in the external value of the dollar—the trade deficit, the non-oil merchandise trade deficit in real terms seems to have hit bottom in the second quarter of 1986. Both the third and the fourth quarter were modestly better.

I fully recognize that many parts of the world are showing signs of sluggish economic growth. But my sense is that the powerhouses of American industry, the GE's, for example, are becoming quite

successful in taking market share away from their competitors in Japan and in EEC.

GE has had a sensational performance in the recent past. I happen to be a small stockholder. I am very pleased about that. Hitachi, a counterpart in Japan, is not doing well. They have cut executive salaries across-the-board not very many months ago.

I think this is a good metaphor for the kind of momentum which, in the short run, is beginning to build up in the trade sector. So I suppose I think we are going to get a good deal for more short-run improvement in our trade numbers than Dr. Chimerine suggests.

Senator HEINZ. Mr. Chairman, my time has expired. I just ask unanimous consent that my opening statement be put in the record.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR JOHN HEINZ

Mr. Chairman, I would like to join you in welcoming our distinguished panel of witnesses today, in particular, Dr. Meltzer and Dr. Chimerine, who are located in the State of Pennsylvania. I look forward to hearing their testimony today on the state of the economy and monetary policy.

At first glance, January's economic statistics reveal surprising strength despite the recent turnaround in oil prices, and reflect a reduced likelihood of a sharp slowdown in U.S. Economic activity. For example, both the producer price index and industrial production rate increased nearly one-half of 1 percent last month. January also experienced solid gains in aggregate employment of 448,000 net new jobs, with a concomitant rise in overall personal income levels of 0.6 percent.

In addition, the U.S. trade deficit declined in December to $10.7 billion, down from November's deficit of $15.4 billion. This is the smallest trade gap since the $8.1 billion deficit of March 1985. The improvement was due in large part to the substantial decline of the dollar and the associated changes in relative prices for internationally traded goods, resulting in nearly a 25-percent drop in imports.

These are positive economic signs. In fact, they may portend better economic activity, as well as improved industrial competitiveness. This is especially true for the domestic manufacturing sector who may be able to recapture two lost markets, the domestic and foreign.

Despite these indicators, there are other factors which concern me. For example, the healthy gains in production in the last 3 months, together with modest sales gains, have not led to surplus inventories. Automobile sales and housing starts declined last month. While the decline in these sectors may be attributable to the tax reform legislation of last year, the drop-off may also reflect other problems in these sectors. Finally, the consumer price index has risen 0.5 percent in the last 2 months, revealing the risk of inflationary pressures.

Clearly, Mr. Chairman, we are at a crossroads in terms of the country's economic and financial condition. Fed policy to cut dramatically the short-term interest rates last year as well as better factory activity and production performance have diminished the

recession risk. A softer pace in spending and the decline of the dollar have lessened the trade deficit. However, we still have a distance to go before the economy is in balance.

The dollar must decline substantially, even from its current lower level, in order to bring U.S. imports and exports back into balance and to reduce our dependence on the inflow of foreign capital. While recognizing that the lower dollar is depressing the Japanese and German economies, we must continue to encourage their policymakers to provide the offsetting fiscal stimulus. This, in turn, will reduce the need for foreign capital inflows into the United States.

Finally, and not to be ignored in this education, Mr. Chairman, it is incumbent upon us to establish policies to reduce the budget deficit. Any meaningful trade deficit reduction will be offset in the absence of a commensurate budget deficit reduction, no matter how far the dollar falls.

The CHAIRMAN. Before I call on Senator Riegle, let me just say, John, I appreciated your remark about how the way to never have a hangover is not to get drunk, but that is only one way. There is another way that I am afraid some of the panelists are moving in the direction of, and that is, the way to never have a hangover is never get sober. [Laughter.]

You know, the hair of the dog that bit ya. That is, unfortunately a common attribute to many people in this field. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I want to say to the panelists, that I am delighted that you are here today, and I want to study carefully what you have had to say to us. The Senate Finance Committee is also meeting this morning on the revenue aspects of the budget request by the administration, so as a member of that committee, I have been involved in that. And I have just had the head of a major manufacturing company in my State come by to talk about the urgency of the trade situation, a person well known to everybody in the room, who feels that more is going to have to be done before we can have a very happy or sanguine sense as to the future, notwithstanding your comments, Mr. Heinemann, about feeling a little bit better as a small shareholder of GE these days.

NO. 1 DEBTOR NATION

Let me ask this question. We have become the No. 1 debtor nation, and we have done it in a very short space of time. I have a chart that I take around with me to illustrate on a scale graph what it looks like, but the rate of descent from a creditor nation to a debtor nation looks just like the Air Mexico plane looked after its tail was sheared off and an amateur photographer took a picture of it, as it was headed for the ground. That is what that curve looks like, when you put it on a graph scale.

We are adding to the net international debt at the rate of about $1 billion every 2½ days.

Now maybe we have got sort of a miracle turnaround coming in the trade account, but I must tell you, I don't see it, not just from the Michigan point of view, I just don't see it in the numbers. Now maybe it will be there, but I can recall hearing that a year ago

from people who thought that it was coming, and then lo and behold, even though the dollar fell versus the yen and the mark, not much happened. In fact, what did happen was the wrong thing.

The trade deficit with Japan went up substantially, though the dollar was down. Now maybe these reduced salaries at Hitachi and other places or the firm that you mentioned will start to make a difference, but we haven't seen that yet.

My question is this: The New York Federal Reserve Board has now estimated that we are going to owe the rest of the world roughly $1 trillion by 1990. That is their operational estimate, the most recent one that I am familiar with.

Help me size that. What does that mean, in terms of future economic prospects? Can we tolerate a buildup over that period of time of debtor nation status of $1 trillion? Can it go to $2 trillion? If we went from $1 trillion to $2 trillion over a 3- or a 5-year period, does it make any real difference? Can we continue to feel that all the foreign money that is coming to us now that is paying for all the debt that we are incurring; public, private, individual, corporate, will continue to be available, or are we reaching some kind of outer bound of these trend lines that ought to cause us to say to ourselves that we've got a very serious international balance sheet problem?

That is really my question. Do we or don't we? And if we don't now, are these rates of change in these trend lines taking us to that point where we'd better treat it as an urgent matter?

Let me start with you, Dr. Chimerine. You seem ready to respond.

Dr. CHIMERINE. Yes. I think the answer to that question, Senator—and by the way I just notice that I think we have scared away all the newly elected Senators, Mr. Chairman. I hope that after sitting through this hearing, they haven't had second thoughts. [Laughter.]

But anyway, I think the answer really has two parts to it. First, how much are they willing to lend to us? At some point, they may be unwilling to lend us increasing amounts of money as they have, unless we push up our interest rates to make it more attractive for them. So that is the first question.

Second, even if they are willing, even if we can continue to add to our foreign debt at $100 billion or $150 billion a year, that money is not coming free. If that $1 trillion estimate by the end of the decade is right, we are going to be seeing something in the range of $80 billion to $100 billion a year of interest and dividends leaving the country, just getting sucked out of the income structure in this country.

So one way or another, it is going to reduce future living standards. I think that is the real issue. It is not just the foreign debt issue. It is "What does it mean for the economy in general," for living standards, for domestic demand, for to the next generation, and so forth. All of these things are moving us in the direction, in my judgment, of holding down living standards in the years ahead.

Senator RIEGLE. But I still want a reflection from you and the others, is the point where we are now, the rate of change, the rate at which we are adding international debt, the $1 trillion estimate by 1990, are these cause for sufficient alarm in your mind, in terms of testing the outer bounds of structure, the international structure, people's willingness to lend, to cause us to say we are doing some things now to get off those trend lines.

Mr. AXILROD. Yes. In this kind of a situation, and I think Alan Meltzer earlier described it, the living standards will have to decline in the transition to a new period. In these circumstances, the faster you act, in a way, the better. If you let the debt get higher and higher and higher, then the tolerance of the foreigners for holding it will get less and less and less. At that point you risk a drop in the dollar that is extraordinarily sharp. It is impossible to make the domestic adjustments to move resources from purely domestic sectors to foreign sectors very rapidly. So if the dollar drops extremely fast, most of what you are going to get is the inflationary aspects of that because the real adjustments will not be coming along in time. And if the trade deficit drops very fast before we have our budget under control, then you could get the inflationary aspects in spades.

So the sooner we begin making the trade adjustments the better, and I think we have begun making them. The drop in the dollar since February 1985 is certainly critical in that. But we are probably at the point we could well use a little breathing space—get the budget deficit down, get the dollar stabilized, and begin making the trade adjustments gradually. I don't think we should lose patience, as long as we have the process under way.

Dr. MELTZER. May I join in that?

Senator RIEGLE. Yes, please.

Dr. MELTZER. I spent considerable time in my testimony on that point, and I don't want to repeat all of it, but let me make two prints. First, the debt is in dollars, so that we are not in the position of Mexico or Brazil It is important to understand that, because we can try to inflate our way out of the debt. That is, we can reduce the debt by inflation, and we are, in fact, moving to some degree in that direction, I believe.

The longer term problem is, of course that we are going to have, in my estimate, a minimum of 600 to 900 billion dollars' worth of debt. We are going to be paying $60 billion in interest payments by 1990 under the most fortunate of circumstances. That is going to be 1½ percent of the GNP. Think about our problem. 4 percent of the GNP, we have to turn, in order to get the trade balance in balance. When we do that, we've got to do another 1½ percent, in order to get the excess of production overspending, to pay the interest on that debt.

Senator RIEGLE. Right.

Dr. MELTZER. Now it is almost impossible to see a increase in living standards under those circumstances over that period. The real question for the Congress is, what will happen after that. $80 or $60 billion in interest payments is more or less in the bag now. That part of the problem is the result of what we've done up to

now. The question to be resolved is, where are we going to be in 1995, and what should we do? There is a lot that we can do now. We can make our situation in 1995 much better or much worse. The basic problem is that we are producing less than we consume, both publicly and privately. And we have to reverse that. The way to reverse it, in my opinion is, we have got to shift more funds into investment, so that the money we borrow goes into productive investment, which creates productive jobs, which services some of the debt when productive jobs come on stream. We should adopt a productivity-enhancing program, and that productivity-enhancing program, in my opinion, has to have a shift in taxes I know you are not going to like to hear this, because you've just been through tax legislation. We have to shift taxes from investment to consumption. We have to shift spending, both private and public from——

Senator RIEGLE. Don't you mean it the other way around? You mean from consumption to investor?

Dr. MELTZER. No. We have to take the taxes off of investors and put them on——

Senator RIEGLE. I beg your pardon. I understand. Yes.

BROAD-BASED CONSUMPTION TAX

Dr. MELTZER [continuing]. Consumption. That is, we need to go to a broad-based consumption tax. In my opinion, we should take all taxes off of capital. And I remind you, that is what Japan is starting to do. And they need that kind of stimulus far less than we do.

Senator RIEGLE. You know, just as a followup to that, before the other two respond, have you done an analysis to the degree to which the tax bill actually takes effect, sort of works against us and works against the argument that you have just raised?

Mr. MELTZER. Yes. It raises the cost of capital to American industry. All right. There are differences in the estimates of how much it raises the cost of capital to American industry, but it is moving in the wrong direction. We should be moving in the opposite direction. We should be reducing the cost of capital. We should encourage capital-intensive industry, which can produce high productivity, to produce exports for the world.

Senator RIEGLE. May I hear from the other two?

Mr. HEINEMANN. I totally support Professor Meltzer. That was a key recommendation of the Shadow Open Market Committee at our last meeting. I very strongly believe that—and I have said this repeatedly in written material—the Tax Reform Act was upside down. It is a good law for Japan, a bad law for the United States. I strongly support Professor Meltzer's proposal that the corporate taxes be repealed and be replaced with a broad-based consumption tax.

Dr. ROBERTS. At the time of the debate I made those same points, Senator.

Senator RIEGLE. May I ask, just as my time expires, on this question of the build up of the international debt, are either of you very nervous about that, or do you think we can stay on these trend lines here and ride on out to that $1 trillion debt in 1990 and beyond and not suffer horrendous consequences, as a result of that?

Dr. ROBERTS. Well, I have the feeling that there is some self-correcting factors there, just because the build up of the debt is not infinitely sustainable. So I sort of share the point of view of Mr. Axilrod that probably something has got to happen to turn that around. If you remember, it was only, you know, a year or two ago, that everybody was worried about the crisis of the strong dollar, and they were projecting out forever what the effects of this strong dollar was going to be and everyone was testifying the dollar could never come down until the budget deficit did.

And all of that hysteria turned out to be false. So it can be misleading to asume that unsustainable trends can be sustained and taking how are you going to pay the cost, because probably they won't be sustained. So you may never have to pay that cost. Now if, for some reason, we manage to forever do the wrong thing and sustain an unsustainable trend, it is going to be bad, but I hope that people learn from this in more general ways, because when the lesser developed countries were building up massive foreign debts, it was widely interpreted as a good thing for them. And if it was so good for them, how is it so bad for us?

Senator RIEGLE. You know, it is interesting—my time is up—but it seems to me a lot of what they were doing was, in a sense, investing in an infrastructure, an industrial base. They were importing consumer goods and other things, and we are hooked on just the other side of it. We are buying the video recorders and everything else, and as a developed nation, carrying the free world's defense burden. It seems to me, we are totally out of synch with what we ought to be doing at this stage of the game.

Dr. MELTZER. Right on.

Dr. ROBERTS. Well, I wouldn't push that too far, because apparently many of those investments were not successful——

Senator RIEGLE. Well, I am not saying that their strategy worked for them, but that doesn't mean that the strategy that we have, if we are out of synch, is going to work for us any better.

Dr. ROBERTS. I don't think that it is a strategy we have. I think it is a consequence of an unexpected, unanticipated collapse of inflation. The collapse of inflation that occurred was not predicted by anyone, and it set in motion these events. So I wouldn't say it is a strategy, and I think, my monetarist friends here read too much in the decline of the dollar. They see it as some sort of Government strategy to reflate. I just don't think there is a strategy like that. It is not quite clear that government has a strategy as a government.

Senator RIEGLE. It sounds like it is time we had one. Thank you, Mr. Chairman.

PERIODIC RECESSIONS

The CHAIRMAN. Mr. Heinemann—I just have two more quick questions. First, Mr. Heinemann, what do we do in the event a recession comes? I get the impression that some of us feel we could avoid a recession forever.

It seems to me, the price we pay for a free system is recessions periodically. We have had them historically. I don't think we can avoid them. So what do we do in the next recession? Can we follow a policy of having a $300 or a $400 billion deficit? Now Henry

Kaufman said we can't afford a recession. Well, we are going to have one, I think. Can we fight it by an even looser monetary policy? A 23-percent increase in monetary base isn't enough? What do we make it, 50, 100? Then what do we do? Take another drink?

Mr. HEINEMANN. Senator, the business cycle has not been repealed. I think you are correct in implying that policies designed to prevent recessions characteristically create them. And so I think you are on the right track, totally.

I think that mistakes have been made, and we have a real price to pay. I think we can begin to minimize the cost of future recessions by insisting on a monetary policy which is less destabilizing. The amplitude of fluctuations in money growth can be damped down over time. We can have smaller fluctuations in money growth rather than bigger ones. And over time, we can gradually minimize the real cost to the system of the inevitable ebb and flow of economic activity. I don't think we can repeal the business cycle, but we can mitigate it.

As I said in my statement, I think policies that depend on progressively larger perturbations in monetary growth will give us an unstable macroeconomic environment.

The CHAIRMAN. Thank you very much.

Now Mr. Axilrod, I would like to have you make history for us. If you answer this question, you will make history as the first former Federal Reserve official, with the kind of major monetary responsibilities that you had, to ever make an interest rate forecast. [Laughter.]

You are in a position to do that now. You are unleashed. You are in the private sector, so you are perfectly free to tell us, what are the short- and long-term interest rates going to do over the next 6 months?

Mr. AXILROD. Mr. Chairman, I will tell you that, if I may have a little preface to it, and the little preface I would like to have is sort of implicit in many of the things that have been said here already. I like to assume that we really are aiming for smaller price increases than the 3 to 4 percent that we have had over the last 3 or 4 years, though it was less than that last year.

So I am going to assume we are aiming for that. I think, in the interim, before we get there, there is some little risk of a recession, because you can't be sure that this drop in the dollar and the restraint in the budget are going to be so nicely phased that they will be consonent with a sort of a balanced growth. We could have, for example, a sharp drop in the dollar and not as much budget restraint as the Congress seems to be promising. Then we might well have a little excess demand in the economy, with more upward pressure on prices.

In my opinion, if that develops, it ought to be fought by the Fed in the interest of getting to lower price increases over time; in that case, interest rates will rise for a while. I don't think they will rise for very long, because I agree with Dr. Chimerine that, basically, there is not—aside from the international sectors, aside from the exchange rate drop and what that might do—there is not much real strong thrust in the economy, the reason being, real interest rates are still relatively high. Certainly, they are not very, very low. So any further rise in rates is probably going to, fairly imme-

diately, control the economy, cause it to drop off, control the inflation.

On the other hand, I don't think the economy is all that weak. We have made substantial productivity improvements, so I think that once inflation comes under firm control, the sort of the basic strength we have built into the economy over the past several years—for example, productivity improvements in manufacturing—will begin asserting itself. As a result, the economy will relatively promptly begin growing at near its potential. When that happens, interest rates will be a lot lower than they are now, because the rate of inflation will be a lot lower than it is now.

So in my personal opinion, assuming I am right, that the Fed is going to be going to aim at lowering rates of inflation over time, interest rates will be lower over the next year or two. In the interim, however, I want to be somewhat agnostic about rates, because no one can be absolutely certain that they won't have to go higher before they go lower. That's my view on it.

The CHAIRMAN. Thank you very much. Senator Riegle has some questions on that.

LOWER LIVING STANDARDS IN THE FUTURE

Senator RIEGLE. Thank you. Just one other thing, and that is, several of you touched on this and maybe all of you did earlier, about the prospect of lower living standards in the future, that the crunch that we've got to work our way out of and pay off some of the bills that we have accumulated, internationally and otherwise, indicate that, as we look out, there is going to be a reduction of living standard taking place here at some point. How we distribute that is a very complex and sensitive question, or even if we can, from a policy point of view. I would like your judgement as to what kind of a downward adjustment in living standard are we apt to be looking at here, and when it is likely to come. I mean, what are the American people in store for here that may be unique in our contemporary economic history. Certainly, you know, post-World War II history.

Mr. AXILROD. It is difficult to put numbers on it, Senator Riegle, but it is coming right now. For the last 4 years or so—and I may be off a bit in my numbers—our spending in this country has grown about 1¼ points on average per year, more than our output. Now once we start shifting resources into the international sector—to increase export, for example—then that spending has got to come down. What we are going to be confronted with for several years ahead is output growing by whatever our potential is—say 3, 3½ percent—and spending growing less. Depending on how fast an adjustment to country wants to make, spending can grow, say, a half a point to one point less for several years or two or three points less for a couple of years, or we could back ourselves into a sharp recession and get the whole thing over with very promptly. But that is what we are confronted with.

In Japan, for the previous 6 years, their spending grew much less than their output. They have to make the symmetrical adjustment to us, to keep the world economy growing. They've got to get their spending growing more than their output to absorb the resources

that the rest of the world is going to be devoting to the international sector. If they don't do that, then that is something of a downward cast on the economy.

You can't put an exact number on it, but we are in the process of reducing domestic spending now. That will occur until we are in whatever reasonable trade balance, whether it is a little surplus or little deficit that all the world and we are satisfied with. When you reach that point, then spending and output can all begin growing together, because the shift has occurred.

Senator RIEGLE. Let me go right down the table.

Dr. CHIMERINE. I agree, Senator, and again, it is hard to give a number but one way of measuring this phenomenon it is with real incomes or real wages. And, in my judgment, they have begun to stagnate already. We had a temporary increase in real wages last year, because of the decline in oil prices, but now that that is over, real wages are stagnating, and when you add to that the increased debt servicing for most consumers, you can make a case that the average American family will experience either stagnant or modestly declining living standards on average for the next 5 years or longer. It doesn't sound so bad if you already have high living standards, but the problem is, it is not equally distributed. We are seeing a number of people losing relatively high-wage jobs. Most of the new jobs we are creating are at much lower wages. I think that the boom in the stock market, you know, is making a small fraction of the population wealthier. Most others are not benefiting from it.

So we are probably widening the income disparity or income distribution disparity, but if you look at the average, I would agree that about the only thing we all agree on this morning is, at a minimum, living standards will stagnate and probably edge lower on an average basis for the next 5 years. It is hard to measure exactly how much.

Mr. HEINEMANN. I would like pass to Dr. Meltzer for the moment and then come back to something else.

Senator RIEGLE. OK.

Dr. MELTZER. Let me give you a ballpark estimate. Like all estimates by economists, it has large variation around it. We are good at some things, but forecasting isn't one of them. But let me give you a ballpark estimate and tell you how I got it, so it may help you a little bit.

The economy for 100 years has grown at a rate of 3 percent a year. Population is growing at a rate of a one-half to 1 percent a year. So that gives us a base of 2 percent a year, 2 to 2½ percent a year in growth of per capita income.

Against that, we have a trade deficit of 4 percent of GNP, which we have to turn around, plus 1½ percent of GNP that we are going to be paying in interest rates on my estimates, which are lower than the ones that you used. So against our 2 percent minus in per capita income, we have 1½ percent for debt service plus a 4 percent one-time reduction in income to turn the trade balance. You only have to turn the trade balance once. But part of it is permanent. The debt that we have out there, we pay interest on forever. So that gives you some limits, so some idea of the ballpark estimate. It says we may suffer a drop or a slow increase if we close

the trade deficit over the period to 1990, and after that, we are going to have relatively slow growth in living standards.

NEED TO INCREASE PRODUCTIVITY

I agree with Dr. Chimerine that it is not going to be across-the-board. I disagree with Dr. Chimerine when he says that we are creating jobs which are low-paying jobs. We always create low-paying jobs, because we create them for entry level people. We are not doing it at any greater extent in the past 5 years than we have over any other reasonable period of the time. Our problem is not to argue over the past. It is to ask how are we going to turn the problem around, and the answer is, the only way that we have is, to increase productivity, so that output grows a little bit faster.

Senator RIEGLE. I think the part that is different with respect to your last point is, it may well be that we have created lower wage jobs when there has been a job creation spurt. I don't know that we have seen the disappearance of the higher paying jobs at the same time. In other words, the windfall reduction or loss of high value-added, high-income manufacturing wage jobs is really, I think, an extraordinary phenomenon that is going on at the same time.

Dr. MELTZER. You've seen that in the auto industry and in Pittsburgh——

Senator RIEGLE. We are seeing it all over the country.

Dr. MELTZER. But we are also creating high-paying jobs. We are turning out a fair number of college graduates who are going into technical jobs. You know, all these kids who go to Wall Street, and there are large numbers of MBA graduates. There are doctors. They are going into high-paying jobs in service industries. So it is not true statistically. In fact, Bob Samuelson has a column in the Washington Post this morning that says exactly the same thing.

Senator RIEGLE. I understand that, but frankly, it doesn't square with what I am seeing, not just from a Michigan point of view. Last week, we had a group in the Defense Department say that we now ought to consider direct financial subsidies to the computer and semiconductor industry in this country, because it is in trouble. And last year, we imported more high-technology items that we exported.

I mean, we are upside down on that account, apart from cars and trucks, apart from agriculture. And it goes right on across the board. I mean, the problem that I see is exactly the Samuelson column, and if we can't get past understanding what is, in fact, happening outside, you know, textbooks that are 20 years old, I don't think we are going to deal with that problem.

Dr. MELTZER. Whether you are right or I am right, the answer is going to be the same. The answer has to be the increase in productivity, investment that increases productivity.

Whatever we have been doing in the past, it is clear that the only way we are going to solve the problem in the future is to increase productivity.

Senator RIEGLE. I do want to hear from Dr. Roberts and Mr. Heinemann.

Dr. ROBERTS. On this topic, if Congress is to compensate for what it sees as changes in income distribution it's likely to work against

the measures it needs to enhance the productivity. So if Congress does its old ways, it's not likely to help the situation with regard to increasing the productivity.

I agree with what's been said about the implications for our living standards of building up large foreign debt if you're not building it by building productive capacity to pay for it. So we want to be sure we build some more to do that.

But population growth is about as unpredictable as anything else. It could actually decline, in which case it's not clear you would find a surplus of too many people chasing low-paying jobs. So the wild card in all that is the behavior of the population growth and I don't think any of us here can predict it. Not even people who are supposed to be able to predict it can predict it.

Mr. Chairman, are you still giving us 2 minutes at the end?

The CHAIRMAN. At the end, yes, sir. If you want those 2 minutes you can sure have it.

Dr. ROBERTS. Can I take them now or should I wait?

The CHAIRMAN. Take them now.

DOMESTIC BUDGET DEFICIT

Dr. ROBERTS. I want to caution against seeing in the domestic budget deficit an expansionary fiscal policy. I don't think it is an expansionary fiscal policy because it wasn't created in order to be that. It was the effect of the collapse of inflation below expectations, below forecasts.

So, if the domestic budget deficit is in large part a reflection of an unexpected disinflation, it would be a mistake to see it as an expansionary force in the economy.

And if it is not an expansionary force and it's seen as one, it could lead to tighter monetary policy than we could really afford.

Since the collapse in inflation was not anticipated, it affected the budget dramatically, I think it would have been useful if several years ago the Congress and the administration had adjusted the budget to the unexpected component in the decline of inflation. It could have done that by having a 1-year spending freeze instead of fighting over budget shares, a spending freeze would have gone a long ways toward adjusting the budget to this collapse in inflation. Because when inflation collapses unexpectedly, it doesn't bring the spending down hand-in-hand with revenues. And so the failure to make this adjustment to the unexpected disinflation has caused a lot of problems, a lot of misinterpretations, a lot of wrong solutions that are advocated that just confuse everyone and give a continued divided house and prevent any decisive action.

And what I think we all agree on is that we have reached the point where we need to have some decisive action which improves the situation and, therefore, we have to fully assess the costs as well as the benefits of whatever action that we take.

The CHAIRMAN. I take it, Mr. Heinemann, you passed and you wanted to come back. So you make your statement and anybody else who has a closing thought or two, preferably one, let us have it.

Mr. HEINEMANN. I waive my 2 minutes. I just want to respond to Senator Riegle.

Senator, it seems to me that in thinking about the implications of the buildup of the net U.S. foreign debt there are a couple of points that we really haven't talked about here this morning. They are obvious but I think they need to be made.

FOREIGN INVESTMENT IN AMERICAN INDUSTRY

One, the foreign assets in the United States are not going to stay invested in Treasury bills and Treasury bonds. They are going to move into the real economy. That's already started. And I think we need to think in political terms very thoroughly about the implications of very broad-scale, widespread foreign ownership of American industry.

We need to think about the mix of production: What kind of production will be in the U.S. vis-à-vis the home country? Will it all be low end, low-value-added assembly operations or will the high-value-added manufacturing processes also occur here if the company is foreign-owned?

In the auto industry, which I presume you have some concern about occasionally, my sense is that most of the foreign-owned U.S. operations are at the low end of the scheme—the assembly operation.

That is one broad set of concerns. I have to assume, if these numbers are anywhere near correct, that we haven't even begun to see the beginning of the change.

Now by the same token, it's fascinating to contemplate what kind of a convergence may occur between the interest of our principal creditors in our export performance and our own interest in our export performance. Longer term it seems to me our creditors are interested in seeing us not try to inflate our way out of our foreign debt. They are going to be interested in seeing our export performance improve just as we're interested in seeing the Brazilian export performance improve.

I would not be surprised to see, for example, just taking a name out of the air, the Honda plant in Marysville, OH producing for export within a very short period of time. Chrysler now seems to be making the same point in starting to sell U.S. North American produced products in Europe. They're not going to sell very many units there but Mr. Iacocca is making a very important political point in doing this. That is another set of problems.

I also am concerned that there may be some security issues involved here too that don't get much discussion. We saw during the Vietnam War that De Gaulle was able to put an enormous amount of pressure on Lyndon Johnson by withdrawing gold at the wrong time and in the wrong way.

Our creditors, if they become anywhere near as big as we think they're going to become, are going to have an important voice in our political affairs—indirectly, but they are going to be there, just as we have a voice in Mexican or Brazilian or Argentinian affairs today. I think we need to think through very carefully what our longer-run role may be as a superpower if in fact we are going around the world with a tin cup asking for money all the time.

The CHAIRMAN. Anybody else?

Dr. CHIMERINE. Can I have part of my 2 minutes?

The CHAIRMAN. Go right ahead.

Dr. CHIMERINE. First, I'd like to register a strong disagreement with the last comment by Dr. Roberts on the cause of the budget deficit. The slowdown in inflation was a minor factor in these large budget deficits.

The truth of the matter is they were caused principally by the combination of a large military buildup and large tax cuts unmatched by sufficient budget cuts elsewhere. You can blame them on somebody for not making other cuts or you can blame it on the tax cuts or whatever, but the slowdown in inflation was not the major cause.

Second, I agree strongly with your comment, Senator Riegle. I didn't read the article this morning in the Post, but based on the work we've done, a relatively large fraction of the jobs that have been lost in the last several years have been high-paying jobs and a relatively large fraction of the jobs that have been created have been low-paying jobs.

You can point to a few "whiz" kids on Wall Street, but there are a lot more people getting jobs in fast food restaurants or whatever at the minimum wage, and many of them part-time, than there are new jobs on Wall Street.

Third, Senator Heinz asked a question before that I didn't get a chance to respond to about the implications of the decline in the dollar on inflation.

Clearly, the decline in the dollar is going to add to inflation. We can't get the trade deficit down without it.

The key question, though, is whether or not it's going to trigger the kind of wage-price spiral we had in the 1970's, after oil prices rose and ultimately led to the 10 or 12 percent inflation we had.

Underlying conditions strongly suggest no that it won't. We can't avoid some dollar-related inflation, but as long as it doesn't feed into the wage structure, and commodity prices don't start rising, and as long as we have this cushion of a lot of excess capacity, inflation may rise to 3 or 4 percent, but it's unlikely to approach the 7, 8 or 10 percent range.

The last comment I'd like to get equal time for the Monetary Policy Forum, Mr. Chairman. You may not know this, but we have strongly advocated a position of ignoring the growth in M1 in recent years, and that if the Fed had tightened during the last several years because of the strong growth in M1 I think we probably would be in a severe recession right now. I'd like to submit for the record the latest statement of the Monetary Policy Forum on its views on monetary policy.

The CHAIRMAN. Thank you very much. Anybody else want to make a comment?

Dr. MELTZER. I'll take 1 minute. I think the issue before us, Senator, is, as it always is, how do we maintain high productivity and low inflation or price stability in the economy.

I think you're on the right track. We cannot forecast. In studying the records of forecasters—all forecasters, including my own forecasts, Dr. Chimerine's forecasts, the Federal Reserve forecasts—the simple fact is that we cannot tell, on average, whether we're in a recession or a boom in the very quarter in which we're making the forecast. That's the record of forecasting over time.

To guide the economy by that kind of forecasting is to produce the kinds of mistakes we have made repeatedly. The Japanese don't do it. The Germans don't do it. They have much more stable policies and they have higher productivity, not entirely but partly as a result of that. We would do well if we would emulate them in that respect.

I think you're on the right track and I hope you will continue with it.

The CHAIRMAN. Thank you very much, Dr. Meltzer. I want to thank all of you, gentlemen. This has been one of the best panels I've heard in 30 years. It's really been very good, stimulating, different opinions and so forth, and it provides an excellent groundwork for Chairman Volcker, who will appear tomorrow and respond to some of the very excellent points you have raised. Thank you.

The committee stands recessed until tomorrow morning at 10 o'clock.

[Whereupon, at 12:30 p.m., the hearing was recessed, to be reconvened Thursday, February 19, 1987, at 10 a.m.]

FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1987

THURSDAY, FEBRUARY 19, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Dixon, Sasser, Shelby, Graham, Garn, Heinz, Armstrong, D'Amato, Hecht, Gramm, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

We continue this morning with the most important of congressional oversight responsibilities. As I said yesterday, this is probably the most important oversight hearing that any committee of Congress has inasmuch as we have a clear constitutional responsibility. And that is, of course, overseeing the development and implementation of Federal Reserve monetary policy.

We have a clear and exclusive constitutional authority over the money supply. We have delegated the implementation of that authority to the Federal Reserve Board. We cannot and should not delegate our fundamental responsibility, however, for overseeing the implementation and direction of the Fed's action.

As you know, Chairman Volcker, this Senator and, I think, the committee as a whole takes that responsibility very seriously and feels that our duties under the Constitution compel us to challenge the monetary policy which, at least this Senator believes, is inappropriate and perhaps dangerous. Simply said, Chairman Volcker, the present rapid pace of money growth exceeds prudence.

As you know, in 1985, the target range was 4 to 7 percent and you came in with a 12 percent for M1. In 1986, last year, the target range was 3 to 8 percent. I thought it was far too large a range. We came in with 17 percent. As you know, since October, the increase has been 21 percent. On page 26 of your statement for the coming year, you tell us that we're not going to have a target, in effect, for M1. You will monitor it; you will watch it; you will keep close to it. But as the author of the law that mandated the targeting of the aggregates, it seems to this Senator that your failure to provide a target range for M1 violates the spirit—I presume not the letter, but the spirit of the law calling for targets for the various aggre-

gates and especially M1 which is certainly fundamental, not alone and perhaps no longer the most important, but one which is significant.

Current monetary growth rates are unwise in view of the inflationary potential inherent in the falling dollar and continued deficit spending. To make matters worse, we are far more vulnerable to a resurgence of inflation than we were a few years ago given our own massive consumer debt and corporate debt and our position as the world's largest debtor Nation.

If foreign investors lose confidence in our price stability and withdraw their funds, interest rates will go through the roof. In the words of one former Treasury Secretary, "We will then have a recession that will curl your hair." "Knock the ashes off your cigar" may be more appropriate. [Laughter.]

We are sensitive to the enormously complex nature of monetary policy developments. We heard a panel of five internationally known economists yesterday, including your former staff director for monetary policy, Stephen Axilrod, a man whom I know you greatly respect and admire, and who worked for you for years. The analyses and conclusions of these outstanding economists were thorough but conflicting.

Certain principles of monetary economics, however, are not subject to doubt. Among the most important of these is that money growth greater than nominal GNP will result in accelerated inflation. We are aware of the uncertainties associated with the demand for money that have caused the Fed to disregard the rapid growth of the monetary base and M1. Nevertheless, the rough interest rate and inflation rate stability of the past several months should have also stabilized the money demand function, making the aggregates the most appropriate of the available measures of monetary ease.

A look at the growth rates of any of the aggregates reveal monetary growth to be greater than that of nominal GNP and much greater.

With debt, both domestic and international, and exchange rates in as precarious a balance as they are, the Federal Reserve has little room to maneuver. This situation is not likely to change making the best policy, in the judgment of this Senator, one in which money growth should be moderated now rather than risking the need for a drastic and destabilizing reduction later.

We can joke about when to take away the punch bowl, but at risk is something far more serious than just a hangover. That risk is economic collapse, widespread personal and corporate bankruptcies, and rampant unemployment. At risk is the economic future of this Nation and of the world.

Chairman Volcker, we appreciate your being here this morning and look forward to receiving the benefit of your testimony.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

As we meet here this moring to continue the first round of monetary policy oversight hearings for 1987, I believe that it is most im-

portant for us to maintain a balanced view of the current state of the U.S. economy.

Certainly there are problems demanding our attention. The Federal budget deficits and the trade deficits are creating debt burdens that will weigh heavily on future generations. Severe sectoral problems are creating economic hardship for the energy industry, for agriculture, for the real estate industry in certain parts of the country, and for many financial institutions.

At the same time, we are in the midst of an historically long-term economic expansion that began more than 4 years ago. In each year of this expansion, more jobs have been created in the United States than in the combined economies of the next six largest industrial democracies.

Most importantly, the conditions of rising inflation and rising interest rates that have aborted previous postwar expansions are not evident in the U.S. economy today.

Thus, we have a good chance of sustaining this expansion as we work on the budget deficit, the trade deficit and the remaining sectoral problems.

The hearings that began yesterday are of critical importance because of widespread concern that monetary policy may be inadvertantly laying the groundwork for the very conditions—rising inflation and rising interest rates—that could put an end to the expansion.

Growth of the M1 aggregate during 1986 at a rate of over 15 percent—almost double the maximum rate foreseen by the Fed's own target growth range—is raising the most concern. A related issue is: How can Congress meet its monetary-policy oversight responsibilities if the Fed misses its announced target by such a great margin.

At the same time there is also concern over a premature tightening of monetary policy. Such an action also could put an end to the economic expansion.

A healthy economy over the long-term requires healthy financial institutions. Today financial institutions in this country are laboring under some heavy burdens.

Problems in certain economic sectors are creating sever difficulties for many banks and thrifts. These problems are compounded by Congress failure to update the outdated, decades-old financial-structure laws that do no take into account recent changes in financial markets.

An end to the economic expansion brought on by misguided macroeconomic policies would compound the problems already facing our Nation's financial institutions.

Fortunately for our financial institutions, prospects are good for sustaining economic growth with moderate inflation. The time is long overdue, however, to also overhaul our financial-structure laws in light of the ongoing changes in financial markets. This would enable our Nation's banks, thrifts and other financial institutions to play their proper role as pillars of strength for our economy.

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

I want to add just a point that may be somewhat different in tone than the statement that you've just made. That is that I am very uneasy about the prospect of higher interest rates right now and it seems to me that the whole question of how the monetary aggregates are managed leads very quickly to the question of whether or not we should in effect raise interest rates.

I see two major dangers if that were to happen right now. One is that growth would slow down in the economy. The revenue coming into the Government would tend to be less and our budget deficit would widen out, and we've got a terribly serious problem with the Federal budget deficit anyway. I don't want to see it getting bigger because the economy in effect begins to slow down.

The other side of it is, if the cost of capital, which is already very high in this country relative to our major trading partners, is driven even higher by higher interest rates, the trade deficit, which was $170 billion last year, will rise even higher.

I don't want to see American business burdened with a higher capital cost today than it presently is, certainly relative to our major trading partners, and I worry about that effect of higher interest rates. So it's one thing I think to have a concern about how our monetary aggregates are managed and how they look in total, but I think we're walking on a tightrope here and there isn't much room for maneuvering.

It seems to me, on the one hand, while we don't want to reignite inflation, in a sense, our two very dramatic problems right in front of us, the fiscal deficit and the trade deficit, are things that have to be improved and they have to be reduced, and lower interest rates—certainly not higher interest rates—is really the way, I think, to try to give us some measure of improvement in both those areas.

So I would hope that comments today might reflect on these tradeoffs because they are certainly at the heart of these policy decisions.

I thank the Chairman.

The CHAIRMAN. Thank you, Senator Riegle.

Next in line—we do this on the basis of who appeared in the committee first—is Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement. I'm just waiting to hear our distinguished witness.

The CHAIRMAN. Thank you.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

Mr. Chairman, I am pleased to be here this morning to hear the Chairman of the Federal Reserve Board, Paul Volcker, testify on the Federal Reserve's plans for the conduct of monetary policy and the Board's economic forecasts and assumptions. This is an important and sensitive time for the economy. The Federal Reserve has to chart a course through perilous waters to avoid tipping the economy into recession while minimizing inflationary pressures. I know

the Chairman's testimony will be of great value to the committee, and I look forward to hearing from him.

I want to take this opportunity, however, before Chairman Volcker begins, to suggest to the administration that he should be renominated as Chairman of the Federal Reserve Board when his term expires. Paul Volcker has been an outstanding public servant. He enjoys a reputation in the financial community that is unequaled. I do not think we can afford to lose his services to the Nation in these difficult economic times.

I have had the opportunity to come to know the Chairman since I came to Washington. I have been deeply impressed by his dedication to public service, and by the leadership he has provided over the course of his Government career.

I know the Chairman is making a real financial sacrifice by staying in Government rather than moving to the private sector, and I know it may be unfair to him to ask him to stay on. However, I hope the administration will do the right thing and ask Paul Volcker to remain as Chairman of the Federal Reserve, and I hope Paul will find it possible to accept that offer. The old Army recruiting posters used to say "Uncle Sam wants you"; I would paraphrase that to say "Paul, Uncle Sam still wants you."

The CHAIRMAN. I certainly echo that view absolutely.

Next is Senator Bond.

Senator BOND. Thank you, Mr. Chairman. I am here to learn and I look forward to hearing Chairman Volcker's testimony.

The CHAIRMAN. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I am pleased to welcome Chairman Volcker and I may not be able to stay for the hearing but I hope at some point he will address the difficulty we always confront that, on the one hand, he says that we need to do things about our fiscal policy—and I agree with that—on the other hand, if monetary policy moves in what may be the wrong direction, it compounds the fiscal problem. In other words, an upsurge in interest rates may lead to a downturn in the economy and a downturn in the economy will simply compound the fiscal problems. So we're caught once again in trying to balance those two and we obviously need the Fed to be sensitive to that as we try to work out of this situation.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Well, Mr. Chairman, let me join everybody else in welcoming you here. I think as we look back on your period of service, whenever it's over, whether it's over soon or over a long time from now, I think it's clear you will have served in a very difficult period where fiscal policy was often moving in the wrong direction and monetary policy had to take up the slack. I have never been one who has been a Fed basher in terms of blaming the Federal Reserve for all our problems.

I would have to say in looking at the growth of the monetary base that I share some of the concerns of our Chairman. If it

weren't for the situation we face in terms of the inflation rate, if it weren't for the relative flatness of the economy, and regional weaknesses within the economy, I would be quite concerned about the growth of M1.

On the other hand, taking those weaknesses in the economy into account and looking at the fact that M2 is not growing, I have not changed my belief that the money supply and monetary base are important. I guess my problem is trying to decide what is money. So I'm not ready to go back and throw out the money and banking textbook that the money supply is an important factor in the economy. I just don't know whether it needs to be rewritten in terms of what is money.

But in any case, I know you are following the monetary aggregates. At the current time I am not willing to say that I am alarmed. On the other hand, I think the money supply is growing very rapidly. We have worked very hard, at great sacrifice to the economy, to get the inflation genie back in the bottle, and I think it's very important that we continue to monitor what's happening. I think at the current time I am not concerned about the growth in the money supply, but I think it's something we've got to follow very closely, because if the situation should change in the economy dramatically—with the decline in the value of the dollar, obviously the price of imports is going to rise, and we're going to see an increase in the demand for American goods. Our trade deficit is not the result of unfair trade practices by our trading partners, which have not changed dramatically in 20 years. It's, instead, the result of the fact that the highest interest rates in the world in the last 6 years have driven up the value of the dollar and those capital inflows have been offset by a trade deficit. As that process reverses—and it will reverse and is reversing now—at least we're beginning to see the beginnings of it—I think we are going to have to go back and look at our inflation problem, and at that point I think we're going to have to look at these monetary aggregates very closely.

With that, Mr. Chairman, I appreciate your giving me time.

The CHAIRMAN. Senator Armstrong.

Senator ARMSTRONG. Mr. Chairman, I didn't intend to make a statement but I'm tempted to respond to Senator Gramm's observations about Fed bashing. I'll just tell you, Senator, don't knock it until you've tried it. [Laughter.]

I have nothing else, Mr. Chairman.

The CHAIRMAN. Senators D'Amato and Heinz have requested that their statements be inserted in the record.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I would like to welcome Federal Reserve Board Chairman Volcker to the committee this morning. Due to the rumors swirling about Washington and Wall Street about the Fed's course, his appearance before us this morning is most timely.

I am concerned about recent indications that the Federal Reserve may be tightening monetary policy. For example, the increase in interest rates in the last week was caused by fears resulting from the Fed's failure to inject reserves into the banking system when the Federal funds rate was well above 6 percent. The

Fed's inaction made many market participants nervous and this was reflected in the wild, albeit short, gyrations in the short-term Treasury markets. Hopefully, Chairman Volcker will inform us whether or not the Fed is shifting toward a tighter monetary policy or whether it is continuing to pursue the same course as Chairman Volcker indicated during his discussion of these issues before this committee on July 26, 1986.

A shift to a more tightened monetary policy could have drastic results for the economy. Although monetary policy alone is not a cure all to the problems confronting our domestic economy, a tightening or slowing down of the growth of the monetary supply could trigger a recession. The drastic results and the budgetary impact of such a policy were articulated by Paul Craig Roberts in yesterday's hearing. While the potential inflationary impact of an increase in the monetary supply poses a threat that must be considered, the certain recession that can be triggered by drastic reductions of the monetary supply presents a peril that must be avoided.

Chairman Volcker's testimony also emphasizes several points that have been made to the committee in the past regarding the stability, or should I say the relative instability of our domestic economy. Today's testimony again substantiates the assertion that economic forecasting is hardly a precise science. However, certain steps must be taken by the Congress, the President, and the Federal Reserve Board to ensure continued and stable economic growth.

If the economy continues to grow at a moderate rate and if we are going to introduce more stability into the domestic and international economies, then Congress must address two problems that no longer loom on the horizon—these problems are at the front door. The first problem is that the budget deficit must be reduced in as rational and least painful manner as possible. The deficit issue has become a political football with the Congress blaming the President and the President blaming a profligate Congress. Such accusations tend to exacerbate rather than resolve the problem. I am interested in the testimony of Paul Craig Roberts who introduces in his testimony another culpable party in the deficit debacle—the conduct of monetary policy by the Fed. I hope he will elaborate on this point during the hearing. I also hope each of our witnesses will offer their recommendations on how the budget deficit may be cut and whether they think Gramm-Rudman is effectively accomplishing its intended goals.

The second problem confronting our domestic economy is the trade deficit. Frankly, I am tired of hearing the same old arguments about how Americans can't compete; the unions have priced American heavy industry out of the market; and America is losing its technological advantage. I believe these arguments and those advancing draconian protectionist legislation ring hollow when one takes a real look at what's happening to American industry.

American industry is at the forefront of innovation. U.S. companies spend billions on innovation each year and develop new technologies. However, before these new technologies can be put to practical uses, we find that our foreign competitors are using the same technologies, in practical uses, at lower costs. How can they do this? Easy, many of our competitors are stealing us blind.

During our last hearing on the Federal Reserve's monetary policy report, I stated that our so-called trading partners:

> Steal our patents, intellectual property rights, systematically are adjudged guilty in the courts, say we're sorry, pay back penalties, continue the same thing, infringe on patents and then send the products here into the United States. Further, those harmed have limited recourse under the current legal system. At present, even though your copyright may have been infringed or your patent stolen you must then demonstrate that there is substantial danger to the particular industry, before damages can be awarded. Despite the failure of the laws and trade policies pursued to date we hear, oh, yes, we're going to make to make changes. We've been waiting a long time for negotiations or other bilateral approaches to work. We wait in vain. It seems to me, absent any legislative action or some very real enforcement of present trade practices, the policies of the Japanese and others will not change because they lack any incentive to change.

I have not changed my point of view on this subject. I should also note that Chairman Volcker supported my notion of the cause of such competitive trade imbalances and urged us to act. I am sorry to state that in the drive to make America more competitive, we and the administration have yet to consider the steps needed to make technological piracy more punitive. Thank you, Mr. Chairman.

STATEMENT OF SENATOR JOHN HEINZ

Thank you, Mr. Chairman. It is always a pleasure to welcome Chairman Volcker, who may be setting records by making his second appearance in less than one month before the committee.

Mr. Chairman, there are concerns regarding the dramatic growth in the money supply during the past year, particularly in the M1 category. Several of the witnesses yesterday expressed alarm at the fact that M1 grew 17 percent, well exceeding the Fed's target boundaries of 3 to 8 percent. They also noted that 1987 has opened with a further dramatic increase in M1 growth, again considerably ahead of Federal Reserve targets and, in fact, ahead of rates in the 1970's when inflation was at its peak.

These witnesses believe the Fed is ignoring the lessons of history and planting the seeds of disaster because in the long run, the traditional relationship between the supply of money and inflation will prevail. In their view, the Fed's tolerance of excess growth in M1 will trigger a sharp growth of economic activity and an early renewal of inflation.

Other witnesses, while not dismissing monetarism altogether, at least questioned its import. In their view, other factors must be taken into consideration. First, they noted problems with how to define "money" for monetary policy purposes. According to them, the traditional definitions of "money" have changed—especially in the M1 category--and that it might not be an appropriate basis for setting monetary policy.

Second, and perhaps more importantly, they noted that the relationship between M1 and economic growth has changed. In essence, the gross national product is simply not following M1 the way it used to. In fact, GNP has been showing only a moderate growth in recent quarters compared to the rapid growth.

These witnesses pointed out that the same thing has been happening in other Western countries. I think the obvious answer is the sharp decline in interest rates in recent years. Depositors are

now willing to carry more funds in M1 form because it costs less to do so.

Despite these varying views, all the witnesses suggested that the Fed's tolerance on credit could be temporary due to new developments.

One is the recent increase in the price of oil. While this may be a factor, it may take on lesser importance. Today's Wall Street Journal reports that world oil prices have skidded to their lowest level this year. Of course, this could be temporary.

Another important factor is the sharp decline in the value of the dollar relative to other currencies. This has already resulted in rising prices of imports and has the potential of leading to higher prices generally down the road.

Mr. Chairman, I am not sure which of these schools of thought should prevail in the setting of monetary policy. However, I am sure that the debate about whether money should grow on a formula basis or whether judgment should be used in allowing money growth will continue today with Chairman Volcker's testimony.

The CHAIRMAN. Mr. Chairman, I understand that you were asked to confine your remarks to 10 minutes. You've got about 38 pages. That is awful rapid reading.

Mr. VOLCKER. I hadn't gotten that message, Mr. Chairman.

The CHAIRMAN. Well, if you can do it in 11 or 12 minutes, we can extend it from 10, but seriously——

Mr. VOLCKER. Well, I won't read this whole statement, but I think you have raised some questions which I attempt to answer in the statement and I think I ought to take advantage of this opportunity.

The CHAIRMAN. Well, we won't run the light on you. We'll get in trouble with other people by not doing it, but we won't. Whatever time you take, I hope you can do it as rapidly as possible.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Let me say first of all, thank you, Mr. Chairman and Senators. You have our full monetary policy report to the Congress. That includes a lot of details, including projections of the committee and our target ranges and so forth. I would like to take a few minutes before getting to those money supply questions by at least alluding to the broader economic setting.

FIFTH YEAR OF RECOVERY AND EXPANSION

You know that we are now entering into the fifth year of recovery and expansion and I think this is an unusual expansion in more respects in that it's been relatively long already. Among other things, at the end of this 4-year period, we find both the inflation rate and the interest rate lower than when expansion started, which is unusual in itself.

And I think basically the traditional indicators of cyclical problems that we have had in the past are largely absent.

But I do have to emphasize that the economy is struggling with structural distortions and imbalances that for this country have little precedent. You know the facts and outline. The economic ac-

tivity over the past 2 years has been supported very largely by consumption. That's been at the expense of reduced personal savings rates that by world standards were already chronically low. At the same time, the huge Federal deficit is absorbing a disproportionate amount of what savings we have in this country. We have largely escaped the adverse impacts of that for financial markets by drawing on capital from abroad.

In 1986, the capital that we have enjoyed from abroad has actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the Federal deficit. Those are not conditions that are sustainable for long—not particularly when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

Sooner or later that process will stop and the only question is, how? I go over in my statement some possible approaches that I reject and say basically the only reasonable alternative is adopting a variety of measures. It's a complicated process, but it is the only promising prospect to me as opposed to protectionism or permitting inflation to rise or not dealing with the deficit.

We have to draw upon a combination of policy instruments. The results are going to take time, but they will come with greater certainty, and they should be consistent with maintaining growth here and abroad.

They have to be consistent with price stability and with open markets and I think very broadly that is the course upon which we are embarked. And the success of that course is going to require an unusual combination of discipline, patience and international cooperation. But the stakes are such that I don't think we have any choice, not just for the United States but for the world.

I review the progress that has been made. The dollar is at much more competitive levels than it's been. We are making progress at least this year on the deficit question. I think that's going to be harder for you next year. Some of the things contributing to the reduction from a record deficit are temporary and we've got to keep that deficit coming down on an orderly course.

COMPLEMENTARY ADJUSTMENTS

I do spend some time in the statement pointing out the implications for the world economy. We loom very large in that economy. If we move to improve our trade deficit here, it obviously has impacts on others. We would like to see complementary adjustments. I think the world must see complementary adjustments in the major countries with exceptionally large surpluses and that, of course, notably means Japan and Germany, both of which now are experiencing some decline in their net exports but alongside of that I think there's some evidence that their economic activity is faltering. They essentially have the opposite problem that we do, sustaining internal demand while reducing the trade surplus. We're

going to have to diminish internal demand while seeing more demand from abroad.

Certainly they don't find these changes much easier than we do. The design, nature of the measures, are going to have to be their decision, the precise timing—they are all strongly debated, but what really matters is that they do, it seems to me, have a clear responsibility for maintaining a strong momentum of growth in their economies as they absorb more imports from the rest of the world.

I could make similar comments about a few of the newly industrialized countries.

I should at least allude to the fact which is discussed in my statement that the international debt situation remains highly relevant to growth and financial stability around the world. I think there's been progress in that area over the past 4 years, but I think there are clear problems as well. And the fact that world growth has not been as well-maintained as we hoped makes it more difficult for them but, more precisely, right now in recent months, the process of reaching agreement on adequately supportive and timely financing programs for those countries, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed, for a variety of reasons. I think that logjam has to be broken.

Now the implications for broad U.S. policy I think are pretty clear. We have an inescapable responsibility to deal with our budget deficit. We have got to restore internal balance if we're going to restore external balance. And I don't think that responsibility is important just because of our own situation where we are so dangerously dependent on foreign savings, but because of a broader consideration.

Progress abroad, as a practical matter, is likely to be stymied without constructive leadership from the largest and strongest nation. And if we, instead, resort to closing our markets, if we are indifferent to depreciation of our own currency, if we permit inflationary forces to regain the upper hand, there isn't going to be any basis for confidence in the United States, and prospects for complementary action abroad or for growth in the world economy would then be dim indeed.

Second, I think we have to recognize the adjustments do require a shift in financial and real resources into internationally competitive industry and away from consumption and Federal deficits.

Without a sharp rise in overall productivity from the 1 percent or so rate characteristic of the past decade or more, I see no reason to suggest that trend will change abruptly—the recent rate of consumption is simply unsustainable for long. More of our growth needs to be reflected in exports and in business investment and less savings will be available to finance the Government.

Now fortunately, in the manufacturing area, which is the key area of international competition, growth in productivity and restraint on costs have been relatively strong, and that is very helpful, but the challenge is to maintain that performance in the face of a depreciating currency.

Now a lot of policy instruments are involved here, but let me turn to monetary policy which obviously has a critical role to play and it has a great advantage of flexibility.

RAPID GROWTH OF MONEY AGGREGATES

I review in the statement what you have already alluded to—you and others, Mr. Chairman—the rapid growth of the various monetary aggregates, particularly M1 last year. We also reduced the discount rate several times last year. Essentially, I think we have had a generous provision of reserves, a large expansion in money.

I must emphasize that that took place in and appeared justified by an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor—the sudden collapse of the world's most important commodity—oil.

But potentially more lasting indicators of inflationary pressure—the rate of increase in workers compensation and the prices of some services that respond slowly to changes in economic environment, were also trending downward. For much of the year, most commodity prices other than oil measured in dollars were falling despite the depreciation of the dollar in the exchange markets.

Moreover, sizable declines in long-term interest rates seem to reflect some easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and certainly within the Federal Reserve, and I would note that one potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets and at times during the past year such exchange rate considerations did prompt particular caution in the conduct of policy.

Now I review in several pages here, Mr. Chairman, the analytic work that's been done quite intensively through the year to try to get a handle on this growth in the monetary aggregates. I won't take the time to review that here. It is obviously related in substantial part to the declines of interest rates we've had that affects the demand for money. I hope that it reflects some greater confidence in money. It may, to some degree, reflect the exceptional amount of financial activity we've had in markets, but the changes in these relationships, partly growing out of institutional changes, certainly does pose new questions in setting monetary targets to help guide the conduct of monetary policy. In the broadest terms, a leveling, and even some decline, in velocity could be welcomed as an appropriate sign of growing confidence in the value of holding money during a period of disinflation. But explanations revolving around declining interest rates and greater confidence in price stability beg the larger issue.

Not all the increases in money can be adequately explained by interest rate relationships, nor can we be certain about what interest rate is appropriate. We know that confidence is hard to win and easy to lose. We need to be conscious of the fact that the effects of excessive money creation on inflation may only be evident with lags and they may be quite long.

As a consequence, we cannot avoid relying upon a large element of judgment in deciding what, considering all the prevailing circumstances, money growth is appropriate.

Obviously, so far as 1986 is concerned, the Open Market Committee made the judgment that relatively strong growth in the aggregates, and particularly M1, could be accommodated consistent with the more basic objectives of orderly growth and price stability. Neither the rate of economic growth, nor the margins of available resources, nor underlying cost trends, nor the movement of sensitive commodity prices suggested money growth was setting in train renewed inflationary forces.

RAPID RATE OF DEBT

I must say the continuing rapid rate of debt throughout the economy has raised one warning flag. In one sense, the enormous volume of purely financial activity, especially at year end but also at times earlier, reinforced other factors increasing the demand for money. But from another point of view, the ready availability of reserves and money was also a factor facilitating that same increase in purely financial activity.

The implicit dangers in that process should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk. The fact that after 4 years of expansion many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

Restraining more speculative uses of credit by more restrictive monetary policy is, of course, possible. But that blunt approach inevitably has implications for all credit and for the real economy as well as financial activity. It cannot substitute for prudent appreciation of the risks in highly aggressive lending by those engaged in financial markets, reinforced and encouraged by regulatory and supervisory approaches sensitive to the potential problems.

Now in looking at 1987, the Open Market Committee remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation. Consequently, in approaching 1987, it starts with the strong presumption that such growth should be moderated. Reflecting that intent, the tentative target ranges for M2 and M3 set out last July were reaffirmed. While those ranges are only slightly below those set 1 year ago, the Committee expects that the actual outcome should be much closer to the middle of the range and near to the anticipated growth in nominal GNP, assuming interest rates prove to be more stable than in recent years.

While anticipating much slower growth than in 1986, the Committee did not set out a specific target range for M1. Given the developments of recent years, uncertainty obviously remains about the long-term relationship between M1 and nominal GNP in today's institutional setting. That uncertainty about the trend might be encompassed by a relatively wide target range. However, the shorter term sensitivity of M1 currently to interest rates and other economic and financial variables realistically would require

so wide a range, or tolerance for movements outside its bounds, as to provide little guidance for the Committee's operational decisions or reliable information for the Congress or for market participants.

Instead, the Committee will monitor M1 closely in the light of other information, including whether or not changes in that aggregate tend to reinforce or negate concerns arising from movements in M2 and M3. More broadly, the appropriateness of changes in M1 will depend upon evaluation of the growth of the economy and its sustainability and the nature of any emerging price pressures. Among important factors influencing such judgments may be the performance of the dollar in the exchange markets.

I recognize the success of that approach rests on good judgment and a degree of prescience. It is justified only by the fact that setting out a precise M1 target—and weighing it heavily in policy implementation, whatever the circumstances—would run greater risks for the economy.

I must also point out that the sensitivity of M1 to interest rates and other developments will not always work in the direction of relatively high growth. To the contrary, action to reduce the rate of M1 growth, promptly and substantially, would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally. In that connection, the Committee explicitly reserves the possibility, in making shorter run oeprational decisions from meeting to meeting, to use M1 along with M2 and M3 as a benchmark. Conversely, lower interest rates in a context of weak growth and further progress toward reducing inflation pressures would suggest an accommodative approach toward M1 growth.

In fact, as you know, the statistical and other signals provided about economic activity and prices seldom are unambiguous or have the same directional implications for policy. In evaluating the evidence as it does appear, the Committee will naturally be sensitive to the desirability of maintaining the forward momentum of the economy, as well as encouraging greater price stability. Quite obviously, our task in that respect will be eased to the extent fiscal policy is consistent with the needed internal and external adjustments.

INFLATION

Finally, so far as inflation is concerned, what is critical is that the anticipated bulge in prices this year related to identifiable temporary external developments—oil and import prices—not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative upward inflationary process started in the 1960's and then extended well over a decade into the 1980's. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse

change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment. Quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. The implications for caution in the conduct of monetary policy are evident.

Thank you, Mr. Chairman.

[The complete prepared statement of Paul Volcker follows:]

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Testimony by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

February 19, 1987

I appreciate this opportunity to review once again with this Committee the conduct of monetary policy against the background of economic and financial developments here and abroad. As usual, a more detailed review of last year, of the prospective ranges for monetary and credit growth established by the Federal Open Market Committee, and of the Committee's projections for economic activity and inflation are set out in the Board's formal Humphrey-Hawkins Report delivered to you earlier. This morning, I want to concentrate on more general considerations underlying the policy approaches of the Federal Reserve. I will emphasize particularly how those approaches must fit into a broader pattern of complementary action both in the United States and in other countries if the common objective of sustained economic expansion and price stability is to be reached.

The Economic Setting

The current economic expansion -- now extending into its fifth year -- is already among the longest in peacetime

More importantly, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started. Homebuilding is being well maintained, and both capital and labor appear available to support further growth for some time without undue strain on resources. Certainly, conditions in financial markets, with stock prices exuberant and interest rates generally as low as at any time since the mid-1970s, appear supportive of new investment.

But if the traditional indicators of cyclical problems are largely absent, it is also evident that the economy is struggling with structural distortions and imbalances that, for us, have little precedent. Economic activity over the past two years has been supported very largely by consumption. That has been at the expense of reduced personal saving rates that, by world standards, were already chronically low. At the same time, the huge federal deficit is absorbing a disproportionate amount of our limited savings.

history. It is unusual in other respects as well, including the absence of certain signs of cyclical excesses that often develop after years of expansion. For instance, inventories have been held well within past relationships to sales, and spending by manufacturers for plant and equipment has, if anything, been restrained relative to prospective needs.

While the overall rate of economic growth has been rather moderate since mid-1984, averaging about 2-1/2 percent a year, that growth has been maintained despite strong pressures on sizable sectors of the economy. Oil exploration and development activity and agricultural prices have both been heavily affected by worldwide surpluses. Commercial construction in many areas is suffering from earlier over-building. Regions of the country in which those impacts have been particularly large have thus remained relatively depressed. Difficult as those regional conditions have been, however, many of the necessary adjustments are well advanced and other areas of the economy have been moving strongly ahead.

For a time, we have largely escaped the adverse consequences for financial markets of that insidious combination of low saving rates and high federal deficits by drawing on capital from abroad -- the flow of which in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the federal deficit. Those are not conditions that are sustainable for long -- not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need both to generate growth and to earn the money to service the debts.

It is not supportable politically, as the pressures on our industrial base are transmuted into demands for protection.

Ultimately it will not be supportable from an international perspective either, as the confidence that underlies the flow of foreign savings will be eroded.

Sooner or later, the process will stop. The only question is how.

The Broad Policy Approach

In concept, we could shut off the flow of imports by aggressive, broadbrush protectionist measures. But the result would be to drive up the rate of inflation and interest rates here, to damage growth abroad, and to invite retaliation. Instead of sustained and orderly growth, we would invite world-wide recession.

We could try to drive the dollar much lower -- or complacently sit back while the market forces produce that result. But that too would undermine the hard-won gains against inflation, and would risk dissipating the flow of

foreign capital we, for the time being, need. The stability of financial markets would be jeopardized, and export prospects could be undercut by adverse effects on growth abroad.

Faced with similar circumstances, many smaller countries might reasonably embark upon strong austerity programs -- indeed sooner or later would be forced to undertake such programs. Large doses of fiscal and monetary restraint would be taken, risking recession in the short run, but also anticipating that exports would respond vigorously, imports would decline, and their economies would soon resume growth on a much sounder footing. But, in the context of a sluggish growth of the world economy, for the United States to take that course would entail particularly high risks and the results would be problematical at best.

There is a reasonable alternative. It is more complicated, but at the same time much more promising.

We can draw upon a combination of policy instruments to encourage the needed adjustments. Results may take time. But those results will come with greater certainty -- and they should

be consistent with maintaining growth here and abroad, with progress toward underlying price stability, and with open markets.

That is, in fact, the course on which we are embarked. To be sure, its success will require an unusual combination of discipline, patience, and international cooperation. However, given the stakes not just for the United States but for others, I don't think there is any real choice.

Important steps have already been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position. The volume of exports is rising, despite relatively slow growth abroad. The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of a reversal is still lacking. Moreover, while the depreciation of the dollar inevitably carries in its train rising import prices, we have been fortunate that the initial impact on the overall price

level was more than offset by falling oil and other commodity prices. The underlying inflation rate, measured by trends in wages relative to productivity, has continued to fall.

We have also been fortunate that the flow of capital from abroad, buoyed by the rising stock and bond markets here and by some declines in interest rates abroad, has been well maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. That emphasizes the critical importance of moving ahead with further reductions in the federal budget deficit which absorbs so much of our own savings.

The progress being made in that direction this year is heartening. But that can only be a start. The projected reduction of $40 to $50 billion this year is from a record high deficit of more than $220 billion in fiscal 1986 -- more than 5 percent of the GNP -- and it is being assisted by some temporary factors. Progress next year will be harder.

Success in my mind will not be measured so much by whether we meet some pre-ordained arbitrary target but by whether in fact a reasonably steady downward pace in the deficit is maintained as the economy grows -- and maintained by measures that can be sustained, year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

International Consistency

Inevitably, because we loom so large in the world economy, marked improvement in our trade balance will be matched by noticeable deterioration elsewhere. Appropriately, that should take place largely in the major countries with exceptionally large surpluses -- notably Japan and Germany, both of which are now experiencing some decline in real net exports. That process cannot take place smoothly and effectively

unless those countries and others are able to maintain a strong momentum of internal demand.

For years, those countries have been dependent for growth mainly on high and rising export surpluses. In both instances, some shift toward domestic demand was apparent in 1986, encouraged partly by some relaxation of monetary policies. That points in the needed direction. But there are also signs that their growth, overall, may be faltering, as exports have declined. At the same time, relatively high levels of unemployment and unused capacity, together with sharp appreciation of their currencies, offer substantial protection against a resurgence of inflationary pressures that they, understandably, want to avoid.

Quite obviously, the needed reorientation of economic policies -- essentially the complement of our own -- is no easier to achieve in those countries than here. Certainly, the nature and design of the needed measures will be -- indeed

is being -- strongly debated within those countries. What is critical from a world perspective is not the precise nature of the measures or their exact timing, but that, at the end of the day, they are successful in maintaining a strong momentum of growth even as they absorb more imports from the rest of the world.

One danger is that, in the absence of stronger domestic growth, pressures will intensify for more appreciation of their currencies, undercutting further their own economic prospects. Given the size of the exchange rate adjustments already made, greater instability in that area seems neither in their interest nor ours.

Some newly industrialized countries also have clear responsibilities for contributing to a better world balance. Taiwan and Korea, in particular, have or are building external surpluses that are large even by the standards of the traditional industrial powers. Part of that reflects a strong competitive position, but both also maintain a strong wall of protectionist barriers. The very strength of their external positions points --

in the interests of their own citizens as consumers, as well as of world equilibrium -- to the need for more forceful action to increase imports, whether by reducing tariffs, by lifting other trade restrictions or by exchange rate changes.

Success in these efforts, I must emphasize, will not necessarily or primarily be measured by changes in our own bilateral trade vis-a-vis particular countries. An open competitive trading order is by its nature multilateral, and we and others should judge equilibrium in a world-wide context.

In that connection, most of the developing world, already carrying heavy debt burdens, is in no position to revalue currencies or to absorb much higher imports (from the United States or from others) without more or less parallel increases in their exports. In recent years, however, it has been the United States that has, in fact, absorbed the great bulk of what increase in exports Latin America has had -- their exports to Europe and Japan have apparently increased little if at all.

For us to close our markets to them now would assuredly thwart prospects for expansion, and with it the encouraging progress that has been made toward both more open, competitive economies and political democracy. What is needed instead is greater access by those countries to growing markets in Europe and Japan as well as here. The recent changes in exchange rates in the industrial world certainly provide greater incentives for exports of the developing countries to shift to Europe and Japan. At the same time, imports by the developing world from the United States have become much more price competitive than a year or two ago.

The Debt Situation

I cannot neglect emphasizing one further continuing threat to growth and financial stability involving the developing countries. Management of the debt problems of Latin America and some other developing countries is again at a critical stage. The reason is not that progress is absent. To the contrary, most of the heavily indebted countries have been growing -- if for the most

part far below their potential -- debt burdens are tending to move lower relative to exports or other measures of capacity to pay, and new financing needs have been reduced. Perhaps most encouraging, there has been definite, if sometimes hesitant, progress toward liberalizing trade, opening markets, and reducing internal economic distortions, with the World Bank playing a particularly helpful role.

At the same time, any failure of the industrialized countries collectively to achieve a satisfactory rate of growth would clearly impair prospects for the developing countries to find the markets they need. More immediately, in recent months, the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

In their particulars, the reasons are as varied as the complexity of the individual financing programs themselves, most of which require the agreement of hundreds of banks around the world. In some instances, policy set-backs in the borrowing countries have complicated the task. But I also suspect the

very fact that progress has been made over the past five years -- most evidently in reducing the exposure of banks relative to capital to something like half of what it was in 1982 -- has had the unfortunate effect of dulling a sense of urgency and cooperation by some. I do not want to deny the progress. But to fail to carry through on past efforts now would plainly jeopardize much of that success and threaten new strains on the financial system.

Implications for U.S. Policy

Several key implications of all this for the United States should be clear.

First, the process of restoring external balance requires first of all that we tend to our inescapable responsibilities to deal with our budget deficit. That is not just because we are dangerously dependent on foreign savings but because progress abroad is, as a practical matter, likely to be stymied without constructive leadership from the largest and strongest nation. Should we instead resort to closing our markets, be indifferent to depreciation of our own currency, and permit inflationary

forces to regain the upper hand, then there would be no basis for confidence in the United States. Prospects for effective complementary action abroad, or for growth for the world economy, would be dim indeed.

Second, we have to recognize that the needed adjustments will require a relative shift of financial and real resources into internationally competitive industry and away from consumption and federal deficits. Without a sharp rise in overall productivity from the one percent or so rate characteristic of most of the 1970s and 1980s -- and I see no reason to suggest that trend will change abruptly -- the recent rate of increase in consumption is simply unsustainable for long. Instead, more of our growth will need to be reflected in net exports and business investment, and less savings will be available to finance government.

Fortunately, performance with respect to productivity growth and restraint on costs in the key manufacturing sectors has been relatively strong during the period of economic expansion. That reinforces prospects for a stronger competitive

position internationally. The challenge will be to maintain that performance in the face of a depreciated currency, higher import prices, and more sizable needs for new investment to meet domestic and export opportunities.

Finally, achieving these goals in the context of sustained growth and reasonable price stability is beyond the capacity of any single policy instrument. Quite obviously, monetary policy will have a critical role to play. In doing so, it has the potential advantage of more flexibility than other policy instruments. But there will also be a heavy premium on maintaining discipline and sound judgment amid potentially conflicting criteria.

Rapid Growth of Money and Liquidity

Throughout 1986, monetary policy accommodated a relatively rapid growth in the various monetary aggregates: the narrowly measured money supply -- M1 -- grew at a particularly rapid pace. The discount rate was reduced four times by a total of 2 percentage points, more or less in line

with reductions in market interest rates. The degree of reserve pressures, measured by average adjustment borrowings of depository institutions from the Federal Reserve, was relatively low throughout 1986, and has remained so since.

This generous provision of reserves and expansion in money took place in, and appeared justified by, an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor -- the sudden collapse in the price of the world's most important commodity, oil. But, potentially more lasting indicators of inflationary pressure -- the rate of increase in workers' compensation and in prices of some services that respond slowly to changes in the economic environment -- were also trending downward. For much of the year, most commodity prices other than oil, measured in dollars, were falling despite the depreciation of the dollar in the exchange markets. Moreover, the sizable declines in long-term interest rates seemed to reflect some

easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and within the Federal Reserve. One potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets. At times during the past year, such exchange rate considerations prompted particular caution in the conduct of policy. The timing of operational decisions with respect to the discount rate or the provision of reserves was affected; on occasion close coordination with the actions of other central banks was particularly important.

More generally, intensive analytic work during the year suggested that much of the relatively rapid growth in the various monetary aggregates was closely related (with lags) to the rather sharp declines in market interest rates late in 1985 and the early months of 1986. The responsiveness of money demand to changes in interest rates is a well established

phenomenon. What is new in the present institutional setting is the increased sensitivity of that relationship, most particularly for M1. Today, interest rates paid on transactions accounts widely used by individuals are close to rates paid on competing financial instruments. That is because interest rates on those accounts have not declined nearly as much as market rates or those on longer-term deposit accounts. Consequently, there has been a strong incentive to transfer funds to NOW (and to some extent savings) accounts and away from other, less liquid instruments.

Demand deposits, which are largely held by businesses and pay no interest, also grew substantially more rapidly than in earlier years. In part, that was also a reflection of declining market rates; banks demanded larger balances in compensation for services provided businesses, and depositors found alternative uses of liquid balances relatively less attractive.

Because of its composition, M1 was particularly influenced by these shifts and grew by 15 percent. That was far in excess of the target set at the start of the year (when the Federal Open Market Committee drew attention to the uncertainties surrounding that aggregate) and above any postwar historical experience as well.

Both M2 and M3 ended the year within -- but just within -- their target ranges. Even so, the increases of almost 9 percent were about as large as most earlier years, when inflation and the rate of economic growth were higher.

With inflation down and real growth moderate, these rapid increases in monetary growth meant that all measures of velocity (i.e., the ratio of nominal GNP to money) declined. That was particularly evident in the case of M1, the velocity decline of 9 percent was greater than in any year since World War II.

While velocity often moves erratically in the short run and a decline is typical of periods of falling interest rates, last year extended and amplified a pattern that has persisted

since interest rates peaked in 1981 and 1982. The earlier post-war upward trend in M1 velocity of about 3 percent a year -- a trend established during a period of generally rising inflation and interest rates -- clearly does not provide a reasonable base for judging appropriate M1 growth today. Historically, there has been little or no trend in M2 velocity. Even so the current level is historically a bit low relative to other periods of low or declining interest rates.

All of this poses new questions in setting monetary targets to help guide the conduct of monetary policy. In the broadest terms, a levelling, and even some decline, in velocity could be welcomed as an appropriate sign of growing confidence in the value of holding money during a period of disinflation. But explanations revolving around declining interest rates and greater confidence in price stability beg the larger issue.

Not all the increases in money can be adequately explained by interest rate relationships, nor can we be certain about what interest rate is appropriate. Confidence is hard to win

and easy to lose. We need to be conscious of the fact that the effects of excessive money creation on inflation may only be evident with lags -- possibly quite long.

As a consequence, we cannot avoid relying upon a large element of judgment in deciding what, considering all the prevailing circumstances, money growth is appropriate.

Obviously, so far as 1986 is concerned, the FOMC made the judgment that relatively strong growth in the aggregates, and particularly M1, could be accommodated consistent with the more basic objectives of orderly growth and price stability. Neither the rate of economic growth, nor the margins of available resources, nor underlying cost trends, nor the movement of sensitive commodity prices suggested money growth was setting in train renewed inflationary forces.

The continuing rapid rate of debt throughout the economy -- running far above the rate of economic growth since 1982 -- has raised one warning flag. In one sense, the enormous volume of purely financial activity, especially at year end but also at

times earlier, reinforced other factors increasing the demand for money. But from another point of view, the ready availability of reserves and money was also a factor facilitating that same increase in financial activity.

The implicit dangers should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk -- to higher interest rates, to recession, or to both. The fact that, after four years of expansion, many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

Restraining more speculative uses of credit by more restrictive monetary policy is, of course, possible. But that blunt approach inevitably has implications for all credit and for the real econony as well as financial activity. It cannot substitute for prudent appreciation of the risks in highly aggressive lending by those engaged in financial markets,

reinforced and encouraged by regulatory and supervisory approaches sensitive to the potential problems.

The Approach to 1987

In evaluating this experience, the Committee remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation. Consequently, in approaching 1987, it starts with the strong presumption that such growth should be moderated. Reflecting that intent, the tentative target ranges for M2 and M3 set out last July of 5-1/2 to 8-1/2 percent were reaffirmed. While those ranges are only slightly below those set a year ago, the Committee expects that the actual outcome should be much closer to the middle of the range (and near to the anticipated growth in nominal GNP), assuming interest rates prove to be more stable than in recent years.

While anticipating much slower growth than in 1986, the Committee did not set out a specific target range for M1. Given the developments of recent years, uncertainty obviously

remains about the long-term relationship between M1 and nominal GNP. That uncertainty about the trend might be encompassed by a relatively wide target range. However, the shorter-term sensitivity of M1 currently to interest rates and other economic and financial variables realistically would require so wide a range (or tolerance for movements outside its bounds) as to provide little guidance for the FOMC's operational decisions or reliable information for the Congress or for market participants.

Instead, the Committee will monitor M1 closely in the light of other information, including whether or not changes in that aggregate tend to reinforce or negate concerns arising from movements in M2 and M3. More broadly, the appropriateness of changes in M1 will depend upon evaluation of the growth of the economy and its sustainability and the nature of any emerging price pressures. Among the important factors influencing such judgments may be the performance of the dollar in the exchange markets.

I recognize that the success of that approach rests on good judgment and a degree of prescience. It is justified only by the fact that setting out a precise M1 target -- and weighing it heavily in policy implementation, whatever the circumstances -- would run greater risks for the economy.

I would point out that the sensitivity of M1 to interest rates and other developments will not always work in the direction of relatively high growth. To the contrary, action to reduce the rate of M1 growth, promptly and substantially, would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally. In that connection, the Committee explicitly reserves the possibility, in making shorter-run operational decisions from meeting to meeting, to use M1 along with M2 and M3 as a benchmark. Conversely, lower interest rates in a context of weak growth and further progress toward reducing inflation pressures would suggest an accommodative approach toward M1 growth.

In fact, the statistical and other signals provided about economic activity and prices seldom are unambiguous or have the same directional implications for policy. In evaluating the evidence as it does appear, the Committee will naturally be sensitive to the desirability of maintaining the forward momentum of the economy, as well as encouraging greater price stability. Quite obviously, our task in that respect will be eased to the extent fiscal policy is consistent with the needed internal and external adjustments.

Most members believe that GNP growth of 2-1/2 to 3 percent is now likely, although a few individual members have higher or lower projections. Such growth should be consistent with continuing sizable gains in employment and a slight downward tilt in the unemployment rate. Members also agree that the rate of price increase is very likely to be greater than last year, essentially because oil prices are expected to average higher and because of the virtual inevitability of higher import prices. The forecasts bunch in the 3 to 3-1/2 percent area for the GNP deflator.

That would be about as low as in 1985 despite the special factors working toward higher prices this year.

So far as inflation is concerned, what is critical is that such a bulge in prices related to identifiable temporary external developments not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative inflationary process started in the 1960s and then extended well over a decade into the 1980s. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment; quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. The implications for caution in the conduct of monetary policy are evident.

Concluding Comments

In sum, we face, at one and the same time, most difficult and most promising economic circumstances.

They are difficult because there are obvious distortions and imbalances within our economy and internationally. Unless dealt with forcibly and effectively, those imbalances will impair both growth and price stability -- and the adverse implications will be amplified by the effects on other countries. Moreover, those imbalances will not yield to any single instrument of policy, however wisely conducted. Instead, what is required is complementary actions here and abroad -- on budgets, on monetary

policies, and on maintaining appropriate exchange rates and an open trading order.

I know none of that is easy. Many countries are involved, and all of them have tough political decisions to make. Nor are the key decisions entirely in the hands of governmental authorities. American industry, in particular, has the challenge to build upon the efforts of recent years toward effective control of costs and greater efficiency, and to seek out and exploit the greater market opportunities that exist today. Banks around the world, despite the frustrations building over time, will need to maintain and reinforce their efforts to deal cooperatively and constructively with the pressing debt problems of their borrowers at home and abroad.

From one point of view, it may seem like a lot to ask. But equally, there is a lot to be gained.

We already have achieved a long economic expansion. We have managed to combine that with progress toward price stability -- and that progress has made possible lower interest

rates. Financial markets more generally reflect renewed confidence. And the broad outline of policies that can preserve and extend those gains are by now well known.

To fail to act upon those policies -- to instead retreat into protectionism, to relax on inflation, to fail to deal with the deficit -- may in some ways appear to be the course of least resistance. But those are also precisely the ways by which we would turn our back to the bright promise before us.

It is only a concerted effort here and abroad that will extend and reinforce the economic expansion, consolidate the progress toward price stability, and provide the international environment in which all countries can prosper.

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REPORTING REQUIREMENTS FOR THE FED

The CHAIRMAN. Thank you very much, Chairman Volcker.

Chairman Volcker, let me first ask about that question that I raised with respect to your dropping M1 as far as a specific target is concerned.

I want to read from the law of 1978. It says:

> In furtherance of the purposes of the Full Employment and Balanced Growth Act of 1978, the Board of Governors of the Federal Reserve System shall transmit to the Congress not later than February 20 and July 20 of each year

and so forth,

> The objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted.

Now technically, the law does not spell out a definition of the monetary aggregates, although at the time it was written Congress clearly had M1 in mind. It was only at the request of Chairman Burns that the phrase "monetary aggregates" was used to allow the Fed to report on additional measures of the money supply such as M2 and M3.

The fact that Congress gave the Fed leeway to include additional measures does not mean you have the authority to drop M1 from your reporting requirements. Clearly, M1 is a monetary aggregate, although economists have some dispute about its velocity. In any event, I believe the law does not give you leeway to ignore reporting at least a range on M1.

So my question is, have you obtained an opinion from your general counsel as to whether the Fed has the authority to drop M1 from its Humphrey-Hawkins report and, if not, why didn't you seek such an opinion?

Mr. VOLCKER. I think it's fair to say that our general counsel was present when many of these discussions took place and he raised no objection. I think the clear, plain language of the law as you read it does not necessarily require an M1 target range.

The substance of the matter, as I tried to describe in my statement, is that I don't think it would be of benefit to you or to us or to the public at large to set forth either a target range so extremely wide it's of no operational significance, or set out a target range and say in a variety of circumstances we would expect to be above or below it.

The CHAIRMAN. Let me interrupt at that point and suggest that under those circumstances, why not ask us to change the law?

Mr. VOLCKER. Well, we have not interpreted the law as requiring that in any sense, Mr. Chairman. We have set out several monetary and credit aggregates, as the law calls for, and we have set out the ones that in the present situation seem to us most meaningful.

The CHAIRMAN. Would you dispute the notion that in 1978 when we set this forth we had M1 specifically in mind as the aggregate and then we only yielded to Chairman Burns——

Mr. VOLCKER. Well, I wasn't here during that discussion, but Chairman Burns, I would say, showed a little foresight in taking you away from too single-minded a devotion to M1.

The CHAIRMAN. He didn't take us as far away as you have, however.

Mr. VOLCKER. I compliment the Congress for recognizing his concerns.

The CHAIRMAN. Well, he did several things to us. No. 1, he took us away from just M1; and No. 2, he took us into a range. And the ranges, in my view, have become almost meaningless sometimes. You go from 3 to 8 percent. And then you go to 17 percent in reality. But when you have that big a range, of course, it doesn't mean very much. The ranges mean very little.

Mr. VOLCKER. Well, I think it doesn't mean very much when we have a range of 3 to 8 percent and end up at 15 on the basis of the ranges expressed, to be precise, which is precisely why I don't think it's a contribution to your discussions and to our discussions to set out a range in which neither we have any confidence nor would propose to you to have any confidence in.

The CHAIRMAN. But the value of a benchmark, whether it's 3 to 8 or whether it's 5 or 6 or whatever it is, is that when you do vary from it we have some basis for asking why, challenging it. We have a discussion of it.

Mr. VOLCKER. Right.

The CHAIRMAN. When we have something as vague as saying you're going to monitor it, watch it carefully, and so forth, we don't have any basis for judging whether it's high, low or in-between or what it is.

Mr. VOLCKER. Well, one can argue what is the best way of facilitating a discussion, but I would hope we have this basis. We do have some target ranges and I have tried to set out in the statement some criteria which I think are appropriate for judging movements in M1. That is precisely the point. If we had a cumulating expansion and evident signs and maybe even some signs that aren't conclusive of growing price pressures, a declining dollar, given the sensitivity of M1 now to these variables, a quite low rate of expansion of M1 might be appropriate. And that is what I am suggesting.

It might be below any range that we would set out now and you ought to have that in mind. Conversely, if we had a situation like last year—oil prices plunging, the underlying inflation rate declining, the economy rather sluggish—a rather accommodative approach would be desirable.

It all depends I think, given the current institutional setting, on the economic context in which you are working.

The CHAIRMAN. I want to come back to that. I do want to ask one other question before my time is up.

This is a hearing on monetary policy and I apologize for asking one question off the subject but it's so important and timely I must ask it. My question is on the banking bill this committee will be considering next week. It has been suggested that the FSLIC recapitalization bill is so important that we should deal only with that item and take up other issues such as the nonbank bank loophole and security powers for banks at a later date.

NONBANK BANK AND SECURITIES ISSUES

What is your view on how urgent it is to act on the nonbank bank and security powers issues, and should we postpone action as some have suggested?

Mr. VOLCKER. Well, my view is clearly that those issues are ripe for action, that they should be acted upon. Indeed, failure of the Committee and the Congress to act on those issues would be an abdication of your responsibilities to try to direct change in the financial system in a constructive way.

The CHAIRMAN. Thank you very much, Mr. Chairman.

Senator Garn stepped out, so we will go to Senator Hecht.

GRAMM-RUDMAN

Senator HECHT. Thank you, Mr. Chairman.

Mr. Volcker, you more than anyone else have been given credit for bringing down interest rates and inflation, but I think Congress in the last couple years had a part in it and my illustrious colleague from Texas I think in Gramm-Rudman in bringing the deficit down in deficit reduction.

If we do not adhere to the Gramm-Rudman reductions in the deficit this year, the targets, and go on a spending spree, what is this going to do to interest rates and inflation?

Mr. VOLCKER. If you go on a spending spree, to take that part of the question, and the deficit doesn't decline and increases, I think it will undercut confidence in our economic prospects. I think it would be damaging from the viewpoint of the dollar. I certainly think it would increase inflationary expectations and inflation in fact, and the consequences from the money market standpoint and interest rates and economic prospects would be extremely adverse.

Now whether or not you meet the exact targets that the distinguished Senator from Texas set out, I think it's important to have those targets, I suppose, in the context of the discussion I just had with the Chairman about monetary targets, but I suppose I must make a comment similar to M1. I think what is important is that you maintain that clear downward momentum, if I can say we have that—I'm not sure we do—but maintain the pattern at least this year of a declining deficit in a significant way, not just in 1988 but in the years beyond—are you on a trend that is what the Senator from Texas had in mind that clearly deals with this problem? Whether or not you reach exactly a $108 billion deficit I don't think is in that sense the issue. Are you on a clear and sustainable downward process on the deficit?

Senator HECHT. Well, the 100th Congress has only been in session roughly a month and several times on key votes—are we going to waive the Gramm-Rudman and spend more than budgeted—and I think there's a clear indication that this Congress might not adhere to these limits.

Mr. VOLCKER. Well, when you say $108, that's a limit, that's a rather arbitrary number. What I would urge with all the force at my command is that you maintain the deficit reduction, assuming growth in the economy and forecasts based upon reasonable estimates of growth in the economy—that you maintain a strong downward momentum in the deficit.

Senator HECHT. What I want to do is bring this to the business people back home that I've been associated with all my life, the people that have created all these new jobs. If we do not—let me just be specific. If we do not continue this downward holding the budget and tightening our belt, this will produce higher interest rates.

Mr. VOLCKER. I think that is on a course toward fewer jobs and more inflation.

Senator HECHT. Thank you. Let me just talk about a statement that Secretary Hodel made yesterday. It is possible by the year 1990 we're going to see oil lines again. We all know about the decline in oil production in America and the volatile Middle East.

What will this do to our economy and interest rates if we are forced to pay higher prices for oil?

Mr. VOLCKER. Well, of course, it depends upon how much. We would like a situation in the oil market that I think is not—I would anyway—one that doesn't go up and down so much because that's disturbing in itself. What level of prices is the best level in some sense for a balance in supply and demand around the world that could be sustained—and I think it is a worldwide problem—is the question at issue.

Clearly there is a matter of judgment here insofar as the United States is concerned as to what price maintains reasonably our own oil production, which is probably declining anyway. I think in a sense the more significant question is, because oil is a worldwide commodity, how we best keep the worldwide situation in some kind of reasonable equilibrium for the next 5 or 10 years.

Senator HECHT. Of course, this is a military situation because the Middle East is militarily unstable right now.

Mr. VOLCKER. True.

Senator HECHT. And we have such a huge amount of proportion of oil in that that we have no guarantee.

Mr. VOLCKER. The world's and our reliance on Middle Eastern oil has been going up some recently, but there's a lot of oil in the Western Hemisphere too, and there are a lot of other questions of oil policy from a security standpoint that arise here as well as to what the relative different sources of supply are and to what degree we should be relying upon different sources.

I think it's clear we are import-dependent in any event and we seem to be getting more import-dependent. It's a question of how fast and then many other questions of policy as to how you best assure the supply that we are inevitably going to have to import.

Senator HECHT. When you get in Washington, we call it the beltway area, and for some reason there's always a certain amount of gloom attached to it, but then when you look at what's happening in the world markets, the stock markets particularly, there's nothing but expectation and what's been going on.

Getting back to Congress again, if we do not hold these spending cuts down and interest rates go up, what will this do to the economic situation around the world?

Mr. VOLCKER. I don't know what it will do in the short run to some of those financial markets, but it will be a decided disservice to the economic situation around the world.

As I indicate in my statement, I think there are very heavy responsibilities on the part of other leading economies to take appropriate action. But I think all the lessons of history suggest that if the United States, as the world's strongest and leading economy and power, does not take actions on its own that point in the right direction so far as our own situation is concerned, we are not going to have many people following us in terms of constructive consistent international policies either.

So you're not only talking about a failure of American policy. I think under those circumstances you're not going to get much chance for the right policies abroad and that compounds the risks for the world economy.

Senator HECHT. Thank you. My time is up.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Riegle.

Senator RIEGLE. Chairman Volcker, I am very much concerned about the fact that we have become a debtor nation in the United States within the last 2 years and we are adding new international debt at the rate of about $1 billion every 2½ days. I have made a chart that I just want to show you here. I'll just hold it up because I think it relates very importantly to future monetary policy.

It indicates that going back to 1914 we were a creditor nation without interruption and then when we crossed this line, as I say, within the last 2 years, we have gone into this debtor nation status.

This chart is to scale, as you can see, both by year and in terms of billions of dollars. I'm concerned about several things, but I'm certainly concerned about the velocity of this curve in the sense——

Mr. VOLCKER. You should be.

Senator RIEGLE. Pardon?

Mr. VOLCKER. You should be.

$1 TRILLION DEBT BY 1990

Senator RIEGLE. Well, I think we all should be. The New York Federal Reserve Board has estimated that by 1990 this trend is going to continue and their best estimate is that we will owe the rest of the world roughly $1 trillion based on their current projections.

Now my question is this. Having come into this debtor nation status, having passed Mexico, Brazil, Poland, and all the other debtor nations, when we discussed this yesterday with a panel of economists that were here and others that I've spoken to, they say there is only really two ways to get out of that kind of a debtor's hole, which of course, is getting deeper and deeper every day, and they are: to inflate our currency, and that that's been the historic way in the past for nations to dig out of an international debt situation if they're in a position to do so; and to recognize that there's going to be a very substantial reduction in the United States standard of living in the future. Now how that gets spread across the society is a separate question, but all five economists who were here yesterday covering a broad range of opinion were unanimous in their view that the only way to reconcile that kind of interna-

tional debt is to accept the fact that we're going to have a lower standard of living in the future.

Now I'd like your reaction to that. Do you see this as an urgent problem? Does it lead to those kinds of consequences, in your view? And if it does, doesn't this—whether you're running the Fed or somebody else is—doesn't this set us up for an inflationary spiral at some point in the future simply to try to reconcile that kind of a debtor nation status? I'd like your reaction to that.

Mr. VOLCKER. Well, I obviously think it's a very serious problem. I think it's a total illusion to think you're going to escape it by inflating. You may try to fool some of the people some of the time but you're not going to fool them all all of the time—that old lesson—too recently we've had inflation, and that is no orderly way out of that hole. So I think you just reject that.

Although there are pressures that arise out of this situation that increase the inflationary dangers, there's no doubt about it. If that capital does not continue to flow at present and the dollar is sharply affected, you have a major source of inflationary impetus.

Senator RIEGLE. Are we seeing some of that now with the dollar having declined?

Mr. VOLCKER. Well, you are inevitably seeing an increase in import prices. There's no way you can have this degree of depreciation without import prices going up. They have not gone up nearly in proportion to the depreciation of the dollar because there was a lot of slack there, among other factors. The appreciation of the dollar was relatively recent. Profit margins were very wide. In some of the countries that export to us from which we import in the nonindustrialized world, there obviously haven't been much exchange rate change, and until trade patterns change that's provided some relief.

So we have had an increase. We are having an increase in import prices. We have been somewhat shielded from the effect so far but we would expect those to be more pronounced this year. Last year they were offset by the decline in oil prices.

So if you look at the total net effect, it was minus, from oil and from import prices. Assuming the oil price doesn't go down again, that won't be the case in 1987.

So you do have an inflationary impact from that source and what we've got to do is absorb that without it setting off a cumulative inflationary movement. That I think we can do and that is our job collectively, and it's got particular implications for monetary policy.

So far as reducing the standard of living is concerned, certainly it has implications for the standard of living. There is no escape from that. The increase in consumption has been practically as large as the GNP. That can't happen continuously. That has only been possible because we are importing so much.

Senator RIEGLE. And paying for it with borrowed money.

Mr. VOLCKER. And paying for it with borrowed money. If you're going to stop that process and deal with the debt problem, relatively we're going to have to export more. That will mean consumption cannot rise so fast. I don't think you have to say the standard of living is going to decline. The standard of living will not be rising as fast as it would otherwise rise. There is not doubt about that.

Senator RIEGLE. Well, but if you have to pay off that foreign debt, how do you pay that off without reducing your standard of living to pay it off?

Mr. VOLCKER. It depends on how long you took to pay it off and in what circumstances. If you had to pay off all that debt as fast as it was put on, yes, the standard of living might have to decline. But if we stabilize it I would be happy for a while and in time I'd like to see it paid off. The richest country in the world should be exporting capital, not importing capital. But doing that over a period of time, yes, means our domestic consumption cannot rise as fast as it has been rising unless we have some miraculous increase in productivity, which I don't think you should count on.

Now how does that come about in an orderly way? It will come about in an orderly way by reducing the Federal deficit.

Senator RIEGLE. My time is up. I hope to come back to that subject.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

BANK FAILURES

Chairman Volcker, in testimony before this committee we have heard a great deal about the persistent weakness in agriculture and energy. Certainly in my State, a heavy agricultural State, and in States in the oil patch we've seen this reflected in increasing number of bank failures. In testimony before this committee, FDIC Chairman Seidman has indicated that there will be a significantly higher number of bank failures this year than the 145 last year.

What implications, if any, does this have for monetary policy? What, if any, actions would you propose that Congress might take to alleviate this problem either through stretching out losses over a number of years, providing some sort of partial guarantees for loan write-downs?

Mr. VOLCKER. So far as the implication on monetary policy is concerned, I would read them more as longer term implications. Part of this process reflects the difficulties of adjusting to disinflation. Part of it reflects—not so much in your area, but in some other areas—overexuberance in lending.

I think the greatest contribution we could make to preventing those problems from arising is dealing with the inflation problem over time so that we don't have to reverse the process and get into all these squeezes.

Now obviously, in the agricultural situation, there's just a worldwide problem at the moment that isn't susceptible I think to monetary policy or any other policy except the Government is providing $30 billion a year for the support of agriculture which indirectly obviously helps the lenders as well as the farmers themselves. So there is really rather massive Federal support being given.

I do not see that the situation requires special guarantees or whatever for those banks or for their lenders, against the background that the Government is providing a great deal of support to the farmers themselves.

Senator BOND. You have mentioned in your testimony the great concern over the growing corporate debt load in this country. Are

there steps which you might recommend to Congress that we take in terms either of requiring full financing be available before a takeover or applying margin requirements to takeovers that might responsibly inhibit the growth of that debt?

Mr. VOLCKER. I don't have any recommendations of that sort now, Senator. In the area of margin requirements where we have experience, that is a question we have looked at in the past and made a rather marginal ruling that attracted a great deal of attention at the time. But I don't think those margin requirements are designed to deal with this kind of takeover problem and I'm not sure that that's a tool that can be adequately used.

I think we do have responsibilities, insofar as we supervise the banking system anyway, to encourage prudence in that area. And that is a very important ingredient I think in an overall approach toward the financial problems that I see not just in the corporate area but elsewhere. We have a rapid expansion in consumer credit, mortgage credit and other types of credit. So there are clear implications there.

I think the market itself has to look at some of its practices.

Senator BOND. The Farm Credit System, as you well know, has been running up increasing losses and I understand that Federal Reserve banks are allowed to purchase Farm Credit System securities. What, if any, steps would the Federal Reserve take if there were a funding crisis for the Farm Credit System?

Mr. VOLCKER. Well, I think if there were that kind of liquidity crisis that you suggest, we do have some authorities to lend the money. We also have authority to buy their securities, as you say, but that is an open market authority, if I can make a distinction. Those operations should be conducted entirely with a view toward the monetary and credit base of the country.

If you have a liquidity problem of that sort, the tool would be through the discount window and there is some quite limited direct authority in the Federal Reserve Act for lending to certain elements of the Farm Credit System. It is quite limited. We have broader emergency powers as well.

But I think fundamentally the answer to that question should not be sought simply in Federal Reserve lending—but we do have some authority.

Senator BOND. There has been some speculation that the rising stock market has reflected primarily the increase in the money supply and the falling value of the dollar.

Do you feel that this market rally is driven by liquidity or by basic economic facts?

Mr. VOLCKER. Well, I hate to speculate upon particularly shorter term market movements and I'm not sure my understanding is any greater than the commentary you can read in the paper every day.

I don't trace it to any particular recent increase in the money supply, but as I say in my statement, I think it could be argued that the rather liberal growth of the money supply this year certainly was not inconsistent with more money flowing into the stock market or other areas of the financial markets.

And to the extent that would be determined to be overexuberant or too much credit being created for nonproductive purposes, one

could say, well, is that one criteria for an excessive growth in the money supply? And I think that is a reasonable question.

On the other hand, growth in the money supply or the general tools of monetary policy cannot single out one sector of the economy for restraint and if you're dealing with an overall situation that didn't seem to require more restraint you have a dilemma. That's why you have to rely upon other tools, including supervisory tools.

Senator BOND. Thank you, sir. My time has expired.

The CHAIRMAN. Thank you, Senator Bond.

Senator Dixon.

Senator DIXON. Chairman Volcker, as you know, last year the Congress thought it met the Gramm-Rudman-Hollings threshold requirements which were $144 billion or as much as $154 billion. Now, of course, it appears that the deficit will actually be over $170 billion. Instead of a $36 billion reduction this year to meet the targets without raising taxes, therefore we would have to make a $60 billion cut.

My question to you is, What would be the impact on the economy of that kind of a cut? In other words, is there a risk to the economy if we try to reduce the deficit too fast?

Mr. VOLCKER. Yes, in theory I think you could do it too fast. I think that's more theoretical than real. I have often responded in answer to a similar question, Senator, that I really don't stay awake nights worrying about you reducing the deficit too fast, as a practical matter. [Laughter.]

ACTIVITY OF THE STOCK MARKETS

Senator DIXON. I'm certainly not an expert on the stock market, but I continue to be amazed at how it flourishes while we have what appears to be a recession in agricultural America, a kind of sluggish economy generally. Is what the stock market is doing a sign that things are going to get better and better, or can it be an omen that things are like they were in the 1920's?

Mr. VOLCKER. Well, I'm not going to comment on the stock market specifically. But let me say that in parts of my statement I did not read, I think that we are in a both very difficult and very promising economic situation.

The difficulties are obvious: the chart on debt, the big deficit, regional problems. Those problems can only be dealt with by both a forceful and rather complicated combination of policies. When you've got two or three things to do at the same time, I suppose that's complicated. It's not just a national problem but an international problem. That's the difficulty.

But I think in fact it is also true to say that we have promise that's unparalleled at least for two or three decades. We already have 4 years of expansion. We have inflation coming down, not going up. And that will presumably be interrupted next year to some extent by the rising import prices and the higher oil prices, but the underlying trend of inflation is down.

Interest rates have been moving lower after 4 years of expansion—or did much of last year anyway. We have the ability—we don't have big, traditional type imbalances. We've got that enor-

mous trade imbalance which is more serious in some ways. But we have a chance of having a prolonged business expansion here consistent with greater and greater stability. We haven't had that chance for a long time and I think we have it now. We are perfectly capable of blowing it, but if we don't blow it but we operate correctly and do these difficult things, then I think a lot of confidence is justified. But that is what's at issue.

Senator DIXON. You mentioned interest rates. I've seen predictions that they are going to go up and predictions that they are going to go down. What's your prediction about interest rates?

Mr. VOLCKER. That's a normal market situation and I am delighted to be in the midst of a normal market situation.

Senator DIXON. Mr. Chairman, a recent story in the Washington Times stated:

> Mr. Volcker hinted last week that the Fed would welcome subpar economic growth this year in order to slow business and consumer spending and thus get some control on rising public and private debt.

Is that story accurate and would the Fed welcome subpar economic growth?

Mr. VOLCKER. Well, I didn't read that story, but it may have grown out of some testimony before the Joint Economic Committee a few weeks ago. What I said precisely was in judging progress this year, I think it is less important to worry about precisely what the growth rate is within some limits than worry about whether progress is being made on the structural adjustments that we must make. And I would repeat that statement. I think this is a year where what's critical is that we begin dealing with that trade deficit, that we make progress on the budget deficit, that we keep the inflation rate under good control. If those things are happening, I frankly think it's a somewhat secondary issue whether we're at the top or the bottom of these ranges that we have projected or other people have projected for economic growth.

It is far more important that we are doing the things that will sustain growth into the future than that we buy another quarter's growth or even another year's growth with the implication that that's the end of the road and we have created conditions that will create a recession. That doesn't make any sense.

Senator DIXON. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Thank you, Senator Dixon.

Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, let me say I'm sorry our distinguished colleague from Michigan has left because I can't leave one point he made unrevisited and that's the point about debt.

DEBTOR NATION FROM 1620 TO 1914

Imagine that I have a great big blue and red chart that begins in 1620, and beginning in 1620 we have an unbroken train of debt as we engage in the horrors of a debtor nation from 1620 to 1914. By the logic of our distinguished colleague from Michigan, our Nation would have been filled with misery, penury and woe. And yet, from 1620 to 1914, we became the world's greatest trading nation. We

became an economic and world power and our standard of living grew faster than any nation in the history of mankind.

The idea that somehow being a debtor nation is a catastrophe is absolute nonsense.

What matters—and what I want to go back to is your point—what matters is what you do with the money. A lot of people have become wealthy—nations have flourished by borrowing money if they invest it productively. If, on the other hand, you go out and borrow money and blow it in on a hot weekend, you become poor quickly.

I want to go back and give you a chance to basically say yes or no. Your concern about the debt is primarily what we're doing with the money, that it is funding consumption; much of that consumption is part of the Federal debt. Is that correct?

Mr. VOLCKER. Yes. I was looking for the exact words in my statement to make your point. I say we are spending more than we produce. We are unable to finance at home both our investment needs and the Federal deficit. These are not conditions that are sustainable for long, not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment. It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need to generate growth.

Your comments remind me of a story, a true story, that I can't refrain from saying.

Senator GRAMM. Make it short because the chairman is going to get me and I've got one more question.

Mr. VOLCKER. It's a good story but I'll deprive you of it.

The CHAIRMAN. Go ahead and tell the story and we'll give you a little more time.

Mr. VOLCKER. Well, I once heard a distinguished Finance Minister of a foreign country giving a litany of his current problems about balance of payments, deficits and that and all the rest. The first question he got was like yours, he said:

> Well, back in the 19th century your country was in debt all the time and piling up great balance of payments problems and the country was doing all right. Why didn't we ever hear about the problems?

And he said, "No statistics." [Laughter.]

Senator GRAMM. Also politicians who understood our problems.

I'd like to go to my second question. I'd like to begin it by basically defining the political problem and then ask your response to it.

Every day we hear this assertion that the United States is exporting jobs. I could give you a thousand examples of where people say, "For every $1 billion of trade deficit we're losing 25,000 jobs. We export not goods but jobs." But yet, nowhere do I ever see anybody demonstrate that.

In fact, we have since 1982 created 11.2 million new jobs, more jobs than Europe and Japan put together. Our unemployment, in the midst of this ballooning trade deficit, has gone down. And the nations that have the big trade surpluses have had unemployment go up.

Now when you begin to respond in that way, invariably people say, "Yes, but we're creating jobs making hamburgers, that we're deindustrializing the economy." Yet, the fact is, from 1972-82, we lost manufacturing jobs and from 1982 to today we have gained 406,000 jobs in manufacturing. Real wages, which declined from 1972 to 1982, are rising today, so we are creating more manufacturing jobs. In fact, Japan and Germany are both losing manufacturing jobs. We are gaining manufacturing jobs. Real wages are rising, not declining.

The importance of all this is that the protectionists cloak their argument in a new cloak and that cloak is sort of a lame appeal to nationalism and this assertion that we are losing jobs.

SURGE OF PROTECTIONISM

And I'd like as my final question—and whatever time you've got left please use it—do you see any evidence that a surge in protectionism, the imposition of quotas and tariffs, the limitation on trade—do you see any evidence that those proposals, if implemented, would create more jobs in the United States, raise real wages, raise the living standards of our people, or enhance the well-being of the working men and women of America?

Mr. VOLCKER. No. If I may make—obviously, not only that, I see a threat to our prosperity and the world's prosperity.

Senator GRAMM. So you would say a movement toward reducing trade through the imposition of protectionism would lower jobs, lower standards of living, and compound our economic problems?

Mr. VOLCKER. Yes. I don't want that to be interpreted obviously, nor your earlier comments which I think are accurate, to mean that we don't have a very serious imbalance in our trade position that must be dealt with decisively or that, too, will bring real problems. But not on the arguments that you recite and I think quite correctly refute.

Senator GRAMM. Would you agree, as a final point, that the major cause of our trade deficit is the huge capital inflow that has been produced by our high interest rates?

Mr. VOLCKER. There's a certain amount of chicken and egg here, but certainly the surge in capital inflow beginning some years ago is certainly related to our trade deficit, yes. And the other side of that coin is we needed the capital inflow to finance the budget deficit and you can't have one without the other.

Senator GRAMM. And without it, all of our problems would have been worse?

Mr. VOLCKER. I think given the budget deficit, the problem probably would have been worse, certainly in the short run. I don't know about the long run, but in the short run it would have been worse. And you can't deal with that problem—you're either going to run much lower levels of investment, which obviously will reduce the standard of living, or you've got to run lower budget deficits.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Chairman Volcker, some years ago we were talking here in this committee about the problem of the Federal budget deficit and we took the position—and I think witnesses did and perhaps you did also—that we needed to get a handle on the Federal debt and get our deficit under control. Otherwise, as the Federal Government got out and started borrowing money in the private capital market, what we would witness was a crowding out, which would drive up interest rates here in the United States. And where we all seemed to miscalculate was forgetting the free flow of capital across frontiers. As the debt mounted we did not see the attendant increase in interest rates; what we saw, as you have described this morning, is the financing of a large portion of this indebtedness with capital coming in from abroad—as much as 50 percent of the indebtedness financed with capital from abroad, as I recall, in fiscal year 1986; 25 percent of it being financed with capital flowing in from Japan, if memory serves me correctly.

Now in your statement, Mr. Chairman, you say that this international flow will continue to be available until the confidence that underlies the flow of foreign savings will be eroded.

My question to you, Mr. Chairman, is: When do we get to the saturation point? When is the confidence of foreign investors eroded to the point that they won't invest here in our deficit, and what are the signals that this is coming?

Mr. VOLCKER. Well, my answer to you has to be I do not know but I don't want to find out. I think the whole essence of the problem here is that we should be conducting ourselves so that we do not face that event because when it happens it's too late.

And I think the problem is so evident and so clear that there is no justification for waiting until the worst happens. Even this year we are relying, mainly because the deficit is bigger, on an increasing flow of official capital rather than private capital. Private capital isn't closing the whole current account deficit. That's not a terribly happy sign in and of itself. It's not because most types of capital flow have been particularly reduced—some have gone up—but as the deficit got bigger, they didn't go up by enough to provide the capital we need. And that is one maybe very early warning signal.

RISE IN DEBT ERODES CONFIDENCE

The rise in the debt itself obviously at some point erodes confidence. The decline in the dollar at some point could erode confidence. Now we've avoided most of that, happily. We have avoided it partly because the inflation performance, among other things, has been good. That helps undergird confidence.

It would be a clear and present danger, in my judgment, with respect to foreign capital flows if people thought our inflation was beginning to get out of control again. That would be very alarming in these terms.

Senator SASSER. Mr. Chairman, it's occurred to me with regard to foreign investors that they might be in the same position vis-a-vis the American economy that the FDIC and the Fed were vis-a-vis Continental Illinois. They simply can't afford to let us get into serious economic trouble. They simply couldn't afford to see the Ameri-

can economy go down as a result of a rapid runup in interest rates here because of unavailability of foreign capital.

Would you want to comment on that?

Mr. VOLCKER. Well, there doesn't seem to me to be a credible comment. The Federal Reserve and the FDIC are public institutions with certain responsibilities to deal with situations of that kind. When you're talking about foreign capital, you're talking about thousands and hundreds of thousands and millions of individuals.

Senator SASSER. If I could interrupt just a moment, one of the reasons given for coming in with a massive infusion of capital to keep Continental Illinois going was the detrimental ripple effect throughout the whole economy if we allowed it to go under. I'm not questioning the judgment on that.

Mr. VOLCKER. I understand that, but that's precisely the point. You have institutions here that are charged with taking that into account. When you're dealing with a great variety of foreign investors, they are not responsible for upholding the American economy. They may worry about it, but if they are worried about it what they are going to do is cut and run and not organize a rescue effort. And that's precisely the problem.

Senator SASSER. And you think the Japanese would cut and run on us?

Mr. VOLCKER. Well, individuals, yes. It's not the Japanese Government. You may get some shift.

Senator SASSER. They have a way of seeming to act in unison to me.

Mr. VOLCKER. Well, they have more of a way of acting in unison than other people, but I think it would be a mistake to say they can act against the perceived economic incentives of all the individuals.

Now the governments may indeed—you may get an official capital inflow instead of a public capital inflow. And to some degree you probably would, but that would be a very defensive operation and not a very happy one, and how long that would last is questionable, too.

There will be a capital inflow, looking at it from another perspective, because we're going to have to borrow the money to cover the deficit. The question is, what are the terms and conditions? What will be charged for the capital inflow, not that it's going to disappear. Individuals can take their money out. The collectivity cannot. But if they're not willing to put it in freely, then that has severe repercussions on the exchange rate and on the interest rate.

The CHAIRMAN. Thank you, Senator Sasser.

Senator Heinz.

PROTECTIONISM

Senator HEINZ. Mr. Chairman, I welcome Chairman Volcker once again to these hearings. I apologize for not being here at the outset. We had Secretary Baker down in the Finance Committee testifying on the administration's trade bill and I couldn't help but think about that subject in your response, Chairman Volcker, to a question asked by Senator Gramm.

Senator Gramm asked if protectionism would have an effect on economic growth and standards of living and, undoubtedly, it would have an effect.

But the thought that crossed my mind was this. Fifteen years ago, the Japanese had a standard of living about half of ours. Today, it's about the equal. For the last 15 years, maybe longer, the Japanese have been following a policy of unmitigated protectionism. It has worked for them beyond anybody's expectations, perhaps even—although I don't want to underestimate them—perhaps even theirs.

Why has it worked for them and why would it not work for us?

Mr. VOLCKER. Japan has had a tremendous record of economic growth and productivity increases. I think my question would revolve around how much of that was a reflection of protectionism. There are some other things going on in Japan, like a 20-percent savings rate, a very high rate of investment, big increases in productivity, and a very aggressive, disciplined, active, intelligent work force.

I would look there for the explanations of the phenomena that you describe.

Senator HEINZ. I think those are good explanations for a good part of their economic performance, but is that to say then that their protectionist policy has slowed them down?

Mr. VOLCKER. Well, I don't know. I think at some times it may, but even to the extent that this image of a coordinated Japan rationally maximizing the benefits of protectionism in their particular instance by giving a chance for high productivity industries to get started and expand and all the rest—even if you give some weight to that—and I don't think that's the mainspring of their growth—Japan is still not the United States. They could get by with it. I don't think we can, in terms of retaliation and so forth. But I don't think it's the main spring of their growth.

Senator HEINZ. I assume that earlier in your testimony you made the point—I hope you did if you didn't—that the United States should be doing all those other things that Japan is doing other than protectionism.

Mr. VOLCKER. Many of them anyway.

Senator HEINZ. Of that list, what are the two or three most important ones for the United States?

JAPANESE SAVING RATE

Mr. VOLCKER. Japan, for instance, has had a very high savings rate. We've got a very low one. They're at the top of the international league; we're at the bottom of the international league, and there's quite a difference between the top and the bottom.

I think it would be nice to have a higher savings rate. I did not have a lot of oratory about a higher savings rate because I think as a practical matter we're not going to get it. We've got a long—I'm not saying we can't go above the very low level it is today and I presume that it will, but to make a major change in the savings rate, a large structural change in our rate of savings, I frankly am not very hopeful about. We haven't saved much for 30 years in good times, bad times, under different kinds of policies, different

kinds of legislation, and I think I would be deluding you if I suggested to you there was some answer that you could adopt some law and that's going to have some dramatic change in the savings rate.

Senator HEINZ. What you're saying, at least to me, is quite distressing, even though I suspect you're right. What you're saying is, even if Congress made the tough choices to reduce the budget deficit, even if we found some ways to give more incentives for saving and investment, we would still be so consumer-oriented that we would never generate the savings to improve the productivity that would improve our competitiveness ever again. Now that's a very pessimistic assessment.

Mr. VOLCKER. Well, let me make a distinction, a semantic distinction—what we mean by savings. My comment was about private savings.

What you obviously can do, that is fully within your control, to make a big difference in our overall savings is reduce the Government's dissavings. That you can do. That has been the biggest change in recent years, from a relatively balanced Government position to big dissavings—in the jargon. If you want to increase the savings rate, which we must, that is where to work on it.

Senator HEINZ. One last question. Let's assume we could reduce the Government's dissavings by reducing the budget deficit somehow, magically, to zero. Where would that money go? There's an assumption built into your prescription that it is going to go to corporate savings as opposed to individual bank accounts and then to something. I would like to believe that it would go into savings of either individuals or corporations but I don't see that happening.

Mr. VOLCKER. I'd like to see it go to two places where I think it would go. One is to reduce our dissavings from abroad. We are now borrowing more abroad than all the individuals in the United States are saving. Now that's a pretty sad statistic. We are borrowing more from foreigners than the collective savings of all the individuals in the United States.

So what I would like to do is reduce the dissavings from abroad, which is the same as our trade deficit or technically the current account deficit.

The other place I'd like to see some go is into investment to support productivity and to support the exports that are part of the process of reducing the borrowing from abroad.

Senator HEINZ. Chairman Volcker, I like those goals.

Mr. VOLCKER. I don't think those goals are at all impossible.

Senator HEINZ. My time has expired. Maybe we can come back.

Mr. VOLCKER. Well, I just—after all, the cynical comment I made about increasing the private savings rate by fiddling around with some tax incentives or something, I don't want to be at all pessimistic about the possibility of reducing the government's dissavings. It's within your grasp and that's what will happen.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, I have a written statement I'd like to have included in the record.

The CHAIRMAN. Without objection, it will be included in the record.

COMPARISON TO THE JAPANESE AND GERMANS

Senator SHELBY. Dr. Volcker, following up on the savings subject here, as far as private savings are concerned in the United States, prior to the 15 or 20 years ago—let's say 20 years ago, was the American savings rate near the Japanese or the West German savings rate?

Mr. VOLCKER. No, not in my memory.

Senator SHELBY. When was it? Back in the 1950s or the 1940's?

Mr. VOLCKER. Back before we had the statistics, I guess. I don't know. Not in my working lifetime. That's as near as I can remember.

Senator SHELBY. In other words, the psychology out there is not in the American to save?

Mr. VOLCKER. That's right. For whatever reason, they historically have had very high savings rates. My staff has given me a table going back to 1965 anyway. These are gross savings rates.

Senator SHELBY. This is private savings, is it not?

Mr. VOLCKER. Well, this probably includes the governments. But in any event, their savings rate was 12 percent higher than ours in 1966.

Senator SHELBY. This is the Japanese you're talking about?

Mr. VOLCKER. The Japanese was 12 percent higher than ours. In 1985, it was 15 percent higher than ours. Subtract out the Government deficit—I don't know what it was in 1966—you would get basically no change or relatively no change.

Senator SHELBY. Is the German savings rate similar to that?

Mr. VOLCKER. Well, the German savings rate is currently halfway in between, but I just haven't got the private figures in front of me, but their deficit isn't all that big.

Senator SHELBY. Would you furnish that to me and the committee if you would, private versus Government savings rate?

Mr. VOLCKER. Sure. I'm looking down the list here to find somebody—this is the gross, total, public and private—the only country I can find as low as us is Iceland, offhand—and Greece, I guess.

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Chairman Volcker subsequently furnished the following information for inclusion in the record of the hearing:

Japanese, German, and U.S. Savings Rates
Selected Years, percent of GDP

Japan

	1965	1970	1985
Gross savings	31.5	40.2	31.4
private	25.6	33.1	27.2
public	5.9	7.1	4.2
Less depreciation:			
Net savings	18.1	26.9	17.7
private	12.7	20.2	14.2
public	5.4	6.7	3.5

Germany

	1965	1970	1985
Gross savings	27.2	28.1	22.2
private	21.9	21.8	19.4
public	5.3	6.3	2.8
Less depreciation:			
Net savings	17.8	18.0	9.6
private	12.9	12.2	7.6
public	4.9	5.8	2.0

United States

	1965	1970	1985
Gross savings	21.0	18.1	16.5
private	18.6	17.4	18.4
public	2.4	0.7	-1.9
Less depreciation:			
Net savings	11.2	7.5	3.7
private	10.1	8.2	7.1
public	1.1	-0.7	-3.4

Note: Data are taken from OECD National Accounts. The OECD distinguishes between government current expenditure and government investment. It thus reports greater government saving (or smaller deficit) than would be the case if government saving were measured as revenue less total government expenditure. There are additional small differences between the procedures followed in the OECD national accounts and those used in the U.S. National Income and Product Accounts.

Senator SHELBY. Do you think that some type of legislation would help change that psychology of American consumers' consumption?

Mr. VOLCKER. Well, I'm expressing some skepticism about that, given what it's practical to do.

Senator SHELBY. In other words, an incentive to save?

Mr. VOLCKER. You could pass a tax law and give a bonus for savings and tax consumption very heavily, but I don't think you're going to do that. It would be interesting to see what results that had. I presume it would have some impact, but you have to talk I think in such extreme fashion that it is not within——

Senator SHELBY. A lot of money was pumped through the IRA's into the banks and thrifts.

Mr. VOLCKER. A lot of money was pumped through IRA's, no doubt about it, and that I think is an illustration of what I'm talking about. During most of that period when a lot of money was pumped into IRA's, the overall savings rate declined. What a lot of people were doing was shifting savings they otherwise had into IRA's because they got a tax break.

Senator SHELBY. Dr. Volcker, you said earlier that we being the richest country in the world, we should be exporting capital, not importing it. To export it, we're going to have to create it. We're going to have to save it, are we not?

Mr. VOLCKER. Yes.

Senator SHELBY. It just begs the question.

Mr. VOLCKER. Yes.

Senator SHELBY. If we keep importing capital and keep consuming it, as Senator Gramm was alluding to, and not using it wisely for the future in developing this country—in other words, if we keep paying our national debt and our credit with it and we keep consuming in other ways, what's going to be the answer in 3 or 4 years or 10 years? Isn't the international debt situation versus ours going to be like a Third World nation?

Mr. VOLCKER. Well, I think it just leads you to a dead end, and if you just continue with it, eventually——

Senator SHELBY. A literal dead end?

Mr. VOLCKER. Well, literally in the sense—to get back to Senator Riegle—if you let it go on long enough, the actual standard of living will decline—I don't think we're in that situation yet, but if you don't repair the imbalance you eventually get in that position.

Senator SHELBY. Senator Gramm was also talking about the year 1620 to 1914. During those years when we were importing capital, we were also a developing nation here and used a lot of that capital as such rather than to use it for our basic consumer tastes, is that correct?

Mr. VOLCKER. Yes. Again, we haven't got any statistics for that period.

Senator SHELBY. And we didn't have those big Federal deficits year after year then, for the most part?

Mr. VOLCKER. No, I'm sure—not only for the most part, I think we didn't have them at all during that period. We didn't have the mechanism for running federal deficits. We didn't have a Federal Government then either during part of that period.

Senator SHELBY. We didn't know how, did we? We didn't have the Federal Reserve then, did we?

Mr. VOLCKER. We didn't have the Federal Reserve to print the money, but if you go back to 1620 we didn't have a Federal Government.

Senator SHELBY. Well, that does go back quite a ways.

Dropping over to one other thing, my home State of Alabama and other rural States have not shared in the coast-to-coast or bicoast prosperity that we've had. A lot of it has been on the west coast, a lot of it on the east coast. There are distortions and structural imbalances there.

What is the answer for us dealing here in the Senate with some of this in the Midwest, the South, and the Northwest?

Mr. VOLCKER. Well, I think that gets you into quite different policy issues than we can deal with by monetary policy. Those big depressed areas of the country are largely a reflection of either oil or agriculture and, of course, if you've got both you've got a double whammy. Both of those are similar in a way in that they are both a response I think not to specifically a U.S. problem but a worldwide relative glut of oil or agricultural products. And as you know, that raises a whole lot of issues of agricultural policy and energy policy.

Take the agricultural one, which I presume is more important in Alabama——

Senator SHELBY. But all of this feeds into our monetary policy, doesn't it?

Mr. VOLCKER. Well, it affects the environment in which monetary policy operates as does the relative boom let's say in New England, and you have to look at both of them.

Senator SHELBY. My time has expired. Thank you, Mr. Chairman.

[The complete prepared statement of Senator Shelby follows:]

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, these hearings come at a time when the economy has us all perplexed.

First, I want to commend Chairman Volcker for his leadership and guidance in bringing interest rates down to their lowest level in 9 years and in bringing inflation under control.

Although our economy is in its fifth year of expansion, I detect warning signs on the horizon, both here and abroad, that indicate trouble ahead.

Domestically, I see warning signs from an economy in transition—in transition to a service economy with substantially lower wages. In this respect, I am concerned about the mounting consumer debt and its impact on the economy should we experience a downturn.

I also see warning signs from an expansion that has been geographically uneven. Recent reports indicate that we now have a bicoastal economy and that the expansion has by-passed the citizens of middle America.

Similarly, as a Senator representing a largely rural State, I am concerned about a two-tier economy. Rural areas and communities

are not experiencing economic growth. Agriculture and industries such as textiles, steel and rubber, which were once the very life blood of these communities, have fallen upon difficult times.

Of course, the most serious warning sign is from the twin deficits in our Federal budget and trade with foreign countries.

Internationally, I see warning signs from the Third World debt situation. Witnesses before the committee yesterday stated that our economy is controlled by external forces. While the falling dollar may give us the month-to-month satisfaction of a declining trade deficit, I worry that the dollar's decline threatens our standard of living. Global cost-cutting and the inherent slow-down in expansions abroad may thwart our hopes of economic growth fueled by exports.

Again, I welcome Chairman Volcker and thank him for sharing with us his insights about the economy.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Chairman Volcker, I'm concerned by the exchange that you had with Senator Proxmire right at the outset of the questioning period.

Mr. VOLCKER. On M1?

Senator SARBANES. On the fact that you had not submitted any M1 figures. It's my understanding that this is the first time that the Fed has not done that, is that correct?

Mr. VOLCKER. I believe so, yes.

Senator SARBANES. So the Fed has understood the law heretofore at least to require an M1 target range?

Mr. VOLCKER. No.

Senator SARBANES. Well, then, why has the Fed always submitted the figures heretofore?

Mr. VOLCKER. Because we thought it was useful and provided information disciplined to ourselves, information to the public and to the Congress that was relevant.

Senator SARBANES. Well, do you read the law as enabling the Fed to determine what is useful and to submit that, or that you have to, in effect, interpret the law and submit what the law requires?

Mr. VOLCKER. I think the law requires us to submit some target ranges of credit and monetary aggregates.

FED REPORT TO THE SENATE

Senator SARBANES. No, no, I want to get an answer to my question, whether it's your view that the Fed can determine what to submit or that the Fed is supposed to determine what the law requires it to submit?

Mr. VOLCKER. I think I'm trying to answer that question. I think we are bound to submit some monetary and credit aggregate numbers that are presumably relevant to judging policy and relevant to the conduct of policy. Precisely what those measures are and how they are defined, as I understand it, is up to us.

Senator SARBANES. Let me repeat my question again. Do you think that you are to submit what the law requires or to submit——

Mr. VOLCKER. I'm trying to describe what I think the law requires.

Senator SARBANES. OK. Very good. But your view is that you are to submit what the law requires?

Mr. VOLCKER. Of course.

Senator SARBANES. Now it's a question of what does the law require, is that correct?

Now heretofore, you have perceived the law to require that you submit M1 figures, is that correct?

Mr. VOLCKER. No, not the law by the language of the law. I perceived that M1 was a useful, relevant aggregate to submit consistent with the law. When I perceive it no longer to be relevant in that respect, I don't think the law directs us to submit M1.

Senator SARBANES. Well, now, it doesn't say that. I mean, it says the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar years during which the report is transmitted and it doesn't say "as it may be deemed relevant or not by the Fed."

Let me ask you this question. In preparing this report, the Monetary Policy Report to the Congress, pursuant to the 1978 Act, was discussion held with respect to the fact that an M1 figure was not going to be submitted?

Mr. VOLCKER. Of course. It was discussed and debated on substantive grounds, but I don't think we had any legal argument about it. I don't think there was any difference of opinion that it was not required by law.

Senator SARBANES. That issue did not come up in the discussion at the Fed?

Mr. VOLCKER. That issue did not come up.

Senator SARBANES. No one raised a concern that the failure to submit this particular monetary and credit aggregate might raise—particularly in view of the fact that it had always been submitted in the past, raise a question about complying with the law?

Mr. VOLCKER. As best I can recall it, as a legal matter—there was a lot of debate as a substantive matter—as a legal matter, I do not recall that question being raised.

Senator SARBANES. What was the nature of the substantive debate?

Mr. VOLCKER. Whether it was useful or not, whether it was useful to the committee first of all in its own operations to have it, and second of all, whether it was useful—given the answer to that question, whether it was useful to have a published M1 target.

Senator SARBANES. Is it your view that the Fed could make the judgment that it would not be useful to submit any monetary or credit aggregates and then proceed not to do so?

Mr. VOLCKER. No. I think with the language of the law we would be hard-pressed not to submit any, so we would look for whatever we thought was most relevant. We have changed them in the past. We have redefined M1. We have redefined M2. We have redefined M3. We have changed the credit aggregate that we submit to you.

Senator SARBANES. That's right.

Mr. VOLCKER. The credit aggregate has never had the same weight as the other aggregates, although it doesn't say that in the law.

Senator SARBANES. But having done that, you do then submit them?

Mr. VOLCKER. Oh, yes, as we did this year.

Senator SARBANES. Well, except you left out a major component which has always been submitted in the past.

Mr. VOLCKER. We dropped out at one point bank credit, which had always been submitted in the past, and we dropped it once and we have never readopted it.

Senator SARBANES. In having the substantive discussion, was the issue raised that the line of questioning which both the chairman and I have now directed to you might in fact come up?

Mr. VOLCKER. No.

Senator SARBANES. It was your assumption you could simply leave it out and no one would sort of say how come this happened?

Mr. VOLCKER. I certainly expected people to say why did you leave this out as a matter of substance, and I have 10 pages before you to explain that.

The CHAIRMAN. Would the Senator from Maryland yield, not on his time?

Senator SARBANES. Sure.

The CHAIRMAN. I want to commend the Senator from Maryland. I think it's very, very important that Congress insist that the law be obeyed to the full and I want to make a formal request, Mr. Chairman, that you have your counsel give us a strictly legal opinion. The committee is going to seek independent outside legal opinion on this. I have the greatest admiration and respect for you, as you know. I know that you want to comply with the law, but I think this is a duty that we have as the Congress to make sure that when a law is enacted that it's complied with in full by our agencies.

Mr. VOLCKER. I agree with your philosophy. I would be glad to have our counsel submit such an opinion. I tell you that there was no question in my mind at any time in this procedure that we were not fully and fairly complying with the specific language and the spirit of the law.

The CHAIRMAN. Thank you.

Senator SARBANES. I have no further questions. I think the Chairman has been responsive to Chairman Proxmire's question and we look forward to that material.

[The information referred to follows:]

Chairman Volcker subsequently furnished the following information for inclusion in the record of the hearing:

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

April 6, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Proxmire:

During the course of my testimony on February 19, 1987, you raised a question about whether the Board is required by Section 2A of the Federal Reserve Act to submit a target range for M1 as part of its Semi-Annual Monetary Policy Report to the Congress. It was your view that the decision by the Federal Open Market Committee not to establish a specific target range for M1, although ranges were provided for M2, M3, and for debt, was not consistent with the requirements of this section. You requested an opinion of the Board's General Counsel on this matter.

That opinion has now been prepared and I am enclosing a copy for your review. The General Counsel has concluded that, as a matter of textual interpretation, Section 2A requires a report on the Federal Reserve's "objectives and plans" with respect to the monetary aggregates and if the Federal Reserve has not formulated "objectives and plans" with respect to one particular aggregate, it is not required to report on it. This reading of the text is supported by other provisions of Section 2A, by administrative practice and most importantly by the legislative history.

I have paid particular attention to the legislative history because of your direct involvement in it and because I am concerned that the Federal Reserve maintain the close consultative relationship with the Congress that we have had in the past. I hope that you will agree with us, after going back over the history, that this relationship would not be served by our providing you with a target range for an aggregate that the Committee itself does not feel can provide a reliable quantitative standard for the conduct of policy at a particular point in time.

Our concerns, I suppose, are similar to those raised with you by Chairman Burns in 1975. Those concerns were reflected in the compromise language you developed at the time speaking of both "objectives and plans" and substituting the phrase "monetary and credit aggregates" for the "money supply".

I would be glad to discuss this opinion with you further should you have any questions.

Sincerely,

Paul A Volcker

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

April 2, 1987

MEMORANDUM

Subject: Humphrey-Hawkins Act Reporting Requirements

During the course of Chairman Volcker's testimony on February 19, 1987, before the Senate Banking Committee on the Board's semiannual report to Congress provided for by Section 2A of the Federal Reserve Act, Chairman William Proxmire requested the opinion of the General Counsel of the Board on whether the Board is required by Section 2A of the Federal Reserve Act (12 U.S.C. 225a) to submit a target range for M1 as a part of this report. This question arises because, as noted in the Board's February 19, 1987 report under Section 2A, the Federal Open Market Committee ("FOMC") elected not to establish a specific target range for M1 because of uncertainty about its underlying relationship to the behavior of the economy and its increased sensitivity to interest rate changes due to the deregulation of interest rates and other factors.

The Board, in its Report, stated that the FOMC had established a range of 5-1/2 to 8-1/2 percent for M2 and M3 and

8 to 11 percent for debt as the "Ranges of Growth for the Monetary and Debt Aggregates" for the period from the fourth quarter of 1986 to the fourth quarter of 1987. In addition, the Report noted that while no range had been included by the FOMC for 1987, the FOMC would continue to monitor M1 behavior carefully, assessing the growth of the aggregate in the context of other financial and economic developments. Finally, the Board reported that in the future the FOMC might set more specific objectives for M1.

Section 2A of the Federal Reserve Act, as amended by the Full Employment and Balanced Growth Act of 1978 (92 Stat. 1897) ("Humphrey-Hawkins"), provides in relevant part that

> . . . the Board of Governors of the Federal Reserve System shall transmit to the Congress, not later than February 20 and July 20 of each year, independent written reports setting forth (1) a review and analysis of recent developments affecting economic trends in the Nation; (2) the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the monetary and credit aggregates for the calendar year during which the report is transmitted. . . . Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions. . . . (Emphasis added).

I. ANALYSIS OF THE TEXT

As a preliminary matter, the first question that should be addressed is whether Section 2A requires the reporting of numerical ranges for the monetary and credit aggregates. On its face, the language of the statute is not entirely clear on whether numerical ranges are required. The statute provides that the Board report "objectives and plans . . . with respect to the ranges of growth or diminution of the monetary and credit aggregates. . . ." Id. It might be argued that the only obligation of the Board is to formulate and disclose "objectives and plans" without necessarily establishing and publishing quantitative ranges for the monetary aggregates. There is nothing in the language of the quoted sentence that would prevent the Federal Reserve from formulating its objectives and plans in qualitative terms rather than assigning quantitative values. However, the last sentence of the section quoted above refers to "objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section. . . .", Id. thus expressing a clear expectation for the disclosure of quantitative ranges of growth or diminution of the monetary and credit aggregates.

Moreover, the legislative history and administrative practice support the view that Congress imposed a dual obligation on the Federal Reserve: to establish and publish ranges of growth or diminution of the monetary and credit

aggregates, and to report its objectives and plans with respect to these ranges.

This conclusion is borne out by statements in the record of Congressional action on this subject. For example, the Senate report on the Humphrey-Hawkins Act states that the "Federal Reserve would report its numerical monetary targets for a fixed calendar year rather than a constantly rolling 12 month period." (S. Rep. No. 1177, 95th Cong., 2nd Sess. (Sept. 6, 1978), p.98.) Similarly, the 'Senate Report on Resolution 133 of 1975 notes that "Discussion and disclosure of planned 'ranges of growth or diminution of the monetary and credit aggregates in the upcoming twelve months' will not eliminate all uncertainty about the future growth of the money supply and other aggregates, but it will provide reasonably reliable information about this crucial element in the economic decision making process." (S. Rep No. 38, 94th Cong., 1st Sess. (Mar. 17, 1975) p. 7.) Moreover, the hearing record on the predecessor legislation to Section 2A, which is discussed in detail below, makes it clear that Congress intended that the Federal Reserve report quantitative target ranges for the aggregates to provide a specific focus for consultations with the Federal Reserve on monetary policy.

With respect to the administrative practice, following passage of Humphrey-Hawkins in October of 1978, reports were filed in February and July of 1979 and in February of 1980 with the House and Senate Banking Committees, and hearings were held

by each Committee on the reports. These reports contained numerical monetary aggregate target ranges. However, while the report filed with the House and Senate Banking Committees in July of 1980 retained the ranges contained in the February 1980 report for the remainder of 1980, the report did not contain precise numerical ranges for 1981 since

> . . . most members [of the FOMC] believe it would be premature at this time to set forth precise ranges for each monetary aggregate for [1981], given the uncertainty of the economic outlook and institutional changes affecting the relationships among the aggregates. (Annual Report of the Board of Governors of the Federal Reserve System, 1980, p. 52.)

The absence of numerical ranges for 1981 was criticized in both Senate and House Hearings. (Hearings Before the Senate Banking Committee on the Federal Reserve's Second Monetary Policy Report for 1980, 96th Cong. 2nd Sess., July 21-22, 1980; Hearings Before the House Banking Committee on the Conduct of Monetary Policy, 96th Cong. 2nd Sess., July 23, 1980.) Shortly after the hearings were completed, and before the Senate Report was prepared, the Federal Reserve did submit numerical monetary aggregate ranges of growth for 1981 to Congress. (Letter dated July 29, 1980, printed in Federal Reserve Bulletin, Vol. 66, August 1980, p. 649.) Each such report filed since then has included such ranges, although as noted above the report for February 1987 did not contain a target for M1.

However, this conclusion on the dual obligation to establish and publish quantitative ranges for the monetary and credit aggregates and report on objectives and plans with respect to those aggregates still leaves the question raised by Chairman Proxmire unanswered. It gives no guidance on whether the obligation to report "objectives and plans with respect to the ranges and growth or diminution of the monetary and credit aggregates" requires that the Federal Reserve establish quantitative ranges for all of the monetary aggregates and formulate objectives and plans for all of these ranges, or whether it gives the Federal Reserve broader discretion to be selective about both the ranges and its plans and objectives with respect to those ranges.

Three textual elements of Section 2A give some guidance on the question raised by Chairman Proxmire on the meaning of the statute: the literal emphasis on the Federal Reserve's objectives and plans, the absence of any definition of monetary and credit aggregates, and the discretion to change objectives and plans in the light of changing circumstances.

A. Does the Language on Section 2A Require an M1 Target Literal Construction

First, read literally, if the Federal Reserve does not have "objectives and plans" with respect to a particular measure of money or credit, Section 2A does not require the inclusion of a range for that measure in the semiannual report. When interpreting a statute, analysis must begin with

the language of the statute itself. Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979).

The language of Section 2A only calls for the Federal Reserve to report its objectives and plans with respect to the aggregates for which it has formulated objectives and plans. If it has no such objectives or plans with respect to a particular aggregate, the statute does not require the Board to report to Congress on that aggregate.

B. Federal Reserve Defines the Aggregates

Second, the flexibility intended by Congress in establishing the formulation of goals with respect to the ranges of growth or diminution of the monetary and credit aggregates is also reflected in the fact that Section 2A does not provide definitions of the monetary and credit aggregates. Instead, the definition of the aggregates was left to the Federal Reserve, which defines the aggregates, collects data on them and publishes the data in periodic statistical releases as well as in the Federal Reserve Bulletin. See Rettig v. Pension Ben. Guar. Corp., 744 F.2d 133 (D.C. Cir. 1984).

In this connection it is also important to point out that the Federal Reserve definitions of the monetary aggregates have changed from time to time in response to changes in an evolving financial system. At the time Humphrey-Hawkins was enacted in October of 1978 the Federal Reserve had already begun to change M1. Immediately prior to that date M1 equalled currency plus demand deposits at commercial banks with certain

adjustments. In October the Federal Open Market Committee began to set a target range for M1+ which included M1 and savings deposits at commercial banks, NOW accounts at all depository institutions, credit union share draft accounts and demand deposits at mutual savings banks. In 1980 all of the monetary aggregates were revised and for a period two versions of M1, M1-A and M1-B, were used in order to provide a transition for the introduction of nationwide NOW accounts under the Monetary Control Act.

In this new formulation, M1-A was basically the old M1, not M1+, except that demand deposits held by foreign commercial banks and official institutions, including governmental entities, were removed. M1-B was a more comprehensive measure of transaction accounts which included, along with M1-A, the interest bearing checkable deposits held at all depository institutions -- NOW accounts, automatic transfer accounts, and credit union share draft accounts. In January of 1982, M1-A was dropped and M1-B was redefined as M1.

Because of the changing character of the aggregates in a dynamic economy it is absolutely necessary to have flexibility to adjust the aggregates to changing circumstances. For example, if the definition of M1 was fixed at the time that Humphrey-Hawkins was enacted, today it would not include NOW accounts which have become a substitute for consumer checking accounts and would not provide a meaningful measure of the supply of transactions money.

Federal Reserve definition of the aggregates is entirely consistent with the intention of Congress to leave formulation of goals with respect to the monetary and credit aggregates to the Federal Reserve, and for the Congress to review them to determine their consistency with other national economic policy objectives. Where a particular measure of money or credit has become obsolete or unreliable, it would be entirely consistent with the wording and intent of the statute for this measure to be removed from the definitions of the monetary and credit aggregates. It makes equally good sense, where this has occurred, to interpret the provisions of Section 2A to allow the Federal Reserve to omit formulating goals with respect to the range of increase or diminution of such an aggregate even if this aggregate continued to be calculated and reported.

C. Discretion to Change Objectives and Plans

Third, the last sentence of Section 2A also demonstrates that Congress did not intend that the Federal Reserve should be bound by the objectives and plans stated in its report and that the Federal Reserve has discretion to depart from these objectives and plans, with the only limitation that the departure be reported to the Banking Committees at the next scheduled semi-annual consultation with the Committees, together with an explanation of the reasons for the changes in the System's objectives and plans. This provision, clarifying the Federal Reserve's discretion in

carrying out monetary policy, suggests that if the System has the discretion to diverge from its objectives and plans, it also has the discretion to inform the Committees that the formulation of objectives and plans for a particular measure of money or credit would not be reasonable in the circumstances. In this situation the provision of objectives and plans for that measure of money or credit in its report to the Congress would be materially misleading, and Congress cannot be held to have intended such a result.

II. THE INTENTION OF CONGRESS

This reading of the text of Section 2A is supported by the legislative history of this provision. Reference to the legislative history is particularly important in construing a statute that regulates the relationship between Congress and an administrative agency in carrying out authority delegated by the Congress. See, PPG Industries, Inc. v. Harrison, 660 F.2d. 628 (5th Cir. 1981).

Broadly stated, the legislative history of Section 2A demonstrates that Congress intended that the Federal Reserve inform the Congress of its "objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates" and left to the Federal Reserve the discretion to formulate these objectives and plans, to select the monetary aggregates that were meaningful in implementing these objective and plans, and to define the monetary and credit aggregates which were to be used in implementing these

objectives and plans. This interpretation of Section 2A emerges from the hearings on S.Con.Res. 18, the predecessor to Section 2A, where the language on formulation of plans and objectives with respect to the monetary aggregates was worked out.

These hearings can be best characterized as having resulted in a compromise between the desire of Chairman Burns to consult with the Congress in a general and unspecific manner without quantifying the FOMC's policy objectives, and Chairman Proxmire's goal of putting a quantitative focus on Federal Reserve monetary policy for the near term future as a basis for consultations between the Federal Reserve and the Congress on this policy. This history makes it clear that Chairman Proxmire was dissatisfied with the general nature of Congressional consultations with the Federal Reserve on monetary policy and wanted more than a general description of past actions and future intentions. On the other hand, Chairman Burns and the Board were deeply concerned about the impact of the Resolution on the implementation of monetary policy through Congressional limitations on Federal Reserve discretion in carrying out monetary policy. The legislative history reveals that these conflicting objectives were reconciled by the adoption of the broad and flexible concept of the Federal Reserve reporting its own goals with respect to the monetary aggregates as opposed to any specific measure of the aggregates to avoid any implication of placing a "straitjacket"

on the implementation of monetary policy by the Federal Reserve. (Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong. 1st Sess., February 25 and 26, 1975, p. 46.)

A. The Derivation of Federal Reserve Reporting Requirements

The key language of the Humphrey-Hawkins Act on reporting objectives and plans comes from H. Con. Res. 133 adopted by Congress on March 24, 1975. This Resolution was initially proposed by Congressman Reuss and provided for a direction to the Federal Reserve to conduct monetary policy in the first six months of 1975 so as to reduce interest rates. In the Senate the proposal took the form of S.Con.Res. 18, introduced by Chairman Proxmire on February 12, 1975. This Resolution directed the Federal Reserve to take

> appropriate action in the first half of 1975 to increase the money supply at a rate substantially higher than in recent experience and appropriate to actively promote economic recovery.

It also required the Federal Reserve to consult with Congress at semiannual hearings before the committees on banking "about its money supply growth targets and other monetary policy actions required in the upcoming six months."

Chairman Burns testified on this Resolution on February 25, 1975, and at this hearing the basic policy considerations underlying the Resolution, and the Federal

Reserve's concerns about it, were articulated. (Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess., February 25 and 26, 1975, p. 37, et. seq.) In his opening statement Chairman Burns criticized the proposed Resolution because it would result in a more detailed involvement of the Congress in the implementation of monetary policy. He summed up the Board's position in the two concluding paragraphs of his opening statement:

> In conclusion, Resolution 18 raises in the Board's judgment momentous issues with respect to the role of the Federal Reserve in the economic life of our Nation, whether the Federal Reserve's traditional insulation from political pressures will continue, whether resistance to inflation may not further diminish, and whether the dollar will remain a respected currency around the world.
>
> If the Congress should seek through Resolution 18 to become deeply involved in the implementation of monetary policy, it would enter an intricate, highly sensitive, and rapidly changing field -- with consequences that could prove very damaging to our Nation's economy. We therefore hope that this committee will consider very carefully the consequences for our national welfare that could result from adoption of this resolution. Id. at 43-44.

In reply, Chairman Proxmire stressed the importance of the Resolution as a means of providing information on which the Congress could make intelligent judgments about the course of monetary policy without the Congress becoming involved in the details of implementation of that policy. He said that Congress as an institution "should have a voice in shaping the broad outline of monetary policy -- not the day to day details, but the broad direction monetary policy is taking." Id. at

44. In answer to Chairman Burns' criticism that the directions contained in S.Con.Res. 18 would mean that "Congress would, in fact be making monetary policy, and I do not think that would be wise," Id. at 45, Chairman Proxmire noted that he wanted to go beyond mere consultations to provide a quantitative basis to measure Federal Reserve intentions, but that this quantitative basis would be set as the Federal Reserve's goals for the future conduct of monetary policy. Thus, Chairman Proxmire emphasized the importance of providing additional information on which Congress could base its analysis of Federal Reserve policy, and rejected mere consultations on the ground that he felt "very strongly that if it is going to have any real significance and meaning, we ought to have some focus." Id. at 45.

However, he indicated that in providing that focus the Federal Reserve should have broad discretion. To ensure this unfettered discretion, Proxmire proposed that the quantitative focus he wanted should be based on the Federal Reserve's own goals. He said,

> . . . and that focus is what you intend to do. You can explain the past action of the Federal Reserve, and that is history. It is not very significant, it is not likely to demand the attention or the understanding of the Congress.
>
> On the other hand, if you tell us what your goals are going to be, then we have the basis on which we can focus discussion and understanding. Id. at 46.

At another point, Chairman Proxmire answered the criticism that Congress would become too much involved in the details of monetary policy by emphasizing,

> You set the goals, we don't. You set the goals, we hear them, discuss the goals with you, debate them, try to understand them, and on that basis, reach some understanding on the part of the committee, and on the part of the Congress as to whether or not to proceed in some other way. Id. at 46.

At still another point, Chairman Burns criticized the proposal on the grounds that it would put the Federal Reserve ". . . in a straitjacket and we could damage our country, because we had been put in a straitjacket." Id. at 46. Again, Chairman Proxmire replied by emphasizing that the Congress was asking for the goals to be established by the Federal Reserve which could change if Federal Reserve goals changed:

> I want to make it clear we are not asking for a straitjacket. Those goals are certainly goals. They are not anything that puts you in concrete. You would be perfectly able to vary from the goals, if conditions change, which they often do. Id. at 46.

Finally, as the discussion proceeded, Chairman Proxmire again stressed that the proposal was focused on goals set by the Federal Reserve. He said:

> Furthermore, we say goals. We don't say this has to be the limit either way, on the way the Fed proceeds. We say that it is the goal. Id. at 46.

During the remaining discussions between Chairman Proxmire and Chairman Burns the dialogue turned to the issue of the narrow focus of the Resolution on a growth target with respect to the "money supply." Chairman Burns criticized this emphasis on reporting on the 'money supply' and noted the limited ability of the Board to achieve specific "money supply" targets. It is clear that in the context of the hearing that both Chairman Proxmire and Chairman Burns believed that the term "money supply" referred to M1.[1/] In response to these criticisms, Chairman Proxmire said

> Well, supposing we modify the Resolution to say, "monetary aggregates." Would that help?"

Chairman Burns replied

> I think that would be an improvement. I would like it still better if it read "money and credit aggregates." I am sure you are interested in the credit supply. Id. at 47.

It was obviously the intention of Chairman Proxmire in proposing this change in language to make S.Con.Res. 18 more acceptable by allowing the Federal Reserve greater flexibility

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1/ In introducing this Resolution in the Senate, Senator Proxmire described the money supply as publicly held currency and demand deposits. 121 Cong. Rec. S.3018 (1975). At that time, this definition of the money supply generally corresponded to the Federal Reserve's definition of M1.

in setting its goals by expanding the scope of the elements that the Federal Reserve could take into account in establishing its goals. Moreover, there is no suggestion that the Federal Reserve would be bound by any mechanistic formula in setting its goals with respect to the monetary aggregates. On the contrary, the varying importance of different aggregates in different circumstances was clearly recognized. For example, as the discussion continued concerning the rate of growth in the "money supply," Chairman Burns emphasized that the M1 definition of the money supply, ". . . made sense 50 years ago, 30 years ago, maybe 20 years ago, but not today, as I have testified time and time again." Id. at 48. He argued, and Chairman Proxmire agreed, that there were numerous appropriate measures of money to take into account in formulating monetary policy.

B. S. Con. Res. 18 Modified and Incorporated Into Section 2A

As a result of this discussion, S. Con. Res. 18 was modified in the Senate to require semiannual consultations with both the Senate and House banking committees about the Board's and FOMC's "objectives and plans with respect to the ranges of growth or diminution of monetary and credit aggregates in the upcoming 12 months." (H. Con. Res. 133, 94th Cong., 1st Sess. (1975)) The Resolution also provided that "nothing in this Resolution shall be interpreted to require that such ranges of growth or diminution be achieved if the Board of Governors and

the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions." (Id.)

The Senate language was ultimately adopted by both the House and Senate in H. Con. Res. 133. This Resolution was then carried on essentially unchanged into the Federal Reserve Act through the Federal Reserve Reform Act of 1977 (P.L. 95-188, approved November 16, 1977, 91 Stat. 1387), with the addition of specific reporting requirements with respect to certain economic factors. This addition to the Federal Reserve Act was adopted because H.Con.Res. 133 had expired at the end of 1976, and, although Chairman Burns continued to appear before the Banking Committees as provided by the Resolution, the Congress wished to assure that "these appearances should be regularized and made businesslike by statute." (Hearings before the House Banking Committee on H.R. 8094, The Federal Reserve Reform Act of 1977, July 18, 1977, remarks of Chairman Reuss at p.2.)

C. Conclusions Drawn from the Legislative History

The legislative history clarifies two important points. First, it emphasizes that Congress was looking to the Federal Reserve to formulate "goals" with respect to the ranges of growth and diminution of the monetary and credit aggregates because it did not wish to circumscribe the Federal Reserve's discretion in formulating and implementing monetary policy. The fundamental purpose was to allow Congress to better inform itself about the Federal Reserve's intentions with respect to the future course of monetary policy. To do this, Congress did

not establish arbitrary and objective reporting formula, but sought to continue to rely on the expertise and policy judgment of the Federal Reserve, subject to a requirement that Congress be informed about that policy in a sufficiently precise manner so as to permit a full analysis of the policy and its consequences. This framework is fully consistent with not reporting on ranges for a particular aggregate where the Federal Reserve judges that such ranges would not be useful in the formulation and implementation of policy.

Second, the legislative history clarifies that the term "monetary and credit aggregates" was inserted in the statute in place of the term "money supply" because Congress recognized that the importance of the various aggregates varies and the aggregates themselves change in composition as different kinds of monetary instruments fall into disuse or new instruments rise in importance.

This emphasis on maintaining Federal Reserve discretion through the use of the Federal Reserve's own goals with respect to monetary and credit aggregates that the Congress recognized were flexible and changing provides the answer to the question raised by Chairman Proxmire. The legislative history indicates that if a particular monetary aggregate is no longer reliable or useful as a guide for monetary policy and the Federal Reserve determines not to formulate a goal with respect to that measure, the Congress did

not require the Federal Reserve to make a report to Congress with respect to that element of the monetary aggregates.

This analysis of the legislative history is also supported by the fact that the Federal Reserve has never formulated targets with respect to all of the monetary or credit aggregates. See, Rettig, supra.

III. FEDERAL RESERVE TARGETS DO NOT APPLY TO ALL OF THE AGGREGATES

If Section 2A were interpreted to require the formulation of objectives and plans with respect to each of the monetary and credit aggregates, then the Federal Reserve would have been required since 1975 to formulate goals and report them to Congress with respect to each of the monetary and credit aggregates for which the Federal Reserve maintains data. This in fact has not been the case.

Although the Federal Reserve may monitor or measure a variety of monetary or credit aggregates, it has not historically established target ranges for all aggregates and included them in its reports to Congress.2/ For example, the monetary aggregate "L," total liquid assets in the hands of the public (M3 plus the nonbank holdings of U.S. savings bonds, short-term Treasury securities, commercial paper and bankers

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2/ Money Stock, Liquid Assets, and Debt Measures, Table 1.21, Federal Reserve Bulletin, March 1987 lists the current monetary stock and debt measures.

acceptances, net of money market mutual fund holdings of these assets), is regularly reported in the Federal Reserve Bulletin but no target range for this aggregate has been included in reports to Congress under Humphrey-Hawkins nor has Congress requested targets for this aggregate. Similarly, the Federal Reserve does not target the debt of domestic nonfinancial sectors even though the aggregate is monitored by the Federal Reserve relative to a range expected to be consistent with ranges for money growth. In the past, the Federal Reserve has monitored other monetary aggregates without including them in the Humphrey-Hawkins report.3/

IV. CONCLUSION

The language of Section 2A does not require reports on a particular monetary or credit aggregate if the Federal Reserve has not formulated objectives and plans with respect to such an aggregate. This literal reading of Section 2A is supported by the last sentence of the section which contemplates that the Federal Reserve may change its plans and objectives, subject to reporting the changes to Congress. A requirement that the Board report to Congress on objectives and plans on a changing aggregate that might be abandoned within a short time would not

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3/ See, e.g., Table 1.21, Money Stock Measures and Components, Federal Reserve Bulletin, January 1979 listing money stock measures M-1, M-1+, M-2, M-3, M-4 and M-5. The February 20, 1979 Humphrey-Hawkins report projected targets for M-1, M-2 and M-3 but not M-4 or M-5. (Federal Reserve Bulletin, March 1979, p. 196.)

serve the intention of Congress to use the reporting requirements to provide a focus for its review of monetary policy. Moreover, this conclusion is strengthened by the fact that Congress has not defined the monetary and credit aggregates but has left this task to the Federal Reserve. It is also supported by the fact that the Federal Reserve has never reported plans and objectives on all of the monetary and credit aggregates and such reports have not been requested by the Congress.

Finally, the discretion inherent in the statutory language is borne out by the expressed intention of Congress in enacting Section 2A. It was the intention of Congress to further the monetary policy making process by requiring the Federal Reserve to inform the Congress of the its goals with respect to monetary policy over the coming year in a concrete and quantitative way without limiting the discretion of the Federal Reserve in the formulation and implementation of monetary policy.

This objective would not be served by an interpretation of Section 2A which would require the Federal Reserve to formulate a goal with respect to a range of increase or diminution of a particular monetary or credit aggregate when, in the judgment of the Federal Reserve, such a range would not provide a reliable guide in the formulation and execution of monetary policy. Such a requirement would distort

rather than improve the consultation process between the Federal Reserve and the Congress.

The Federal Reserve has concluded in its February 1987 report that at this time the uncertainties about the relationship between M1 and economic performance are sufficient so as to preclude setting such ranges. Accordingly, it would not be consistent with the text or the stated purpose of Section 2A to require the Federal Reserve to formulate and report goals with respect to M1 in connection with its monetary policy report for February 1987 because the Federal Reserve has not formulated objectives and plans with respect to this aggregate for the period of the report.

Michael Bradfield

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, yesterday Mr. Meltzer of Carnegie Mellon made three suggestions for dealing with Third World debt problems, with particular attention to Latin America.

One was to stop U.S. lending to foreign countries and emphasize trades for debt for equity. The second was to encourage Latin American countries to repatriate their own money. And third, to swap debt for equity at market value.

What would be your response to these suggestions?

DEBT TO EQUITY SWAPS

Mr. VOLCKER. Well, the more equity that could be sent to those countries, the better. And debt to equity swaps are one vehicle and the effectiveness depends upon the particular circumstances and times.

The part that I would question is stop all lending. You're not contributing to the process I think of growth in those countries and our own interest in stable political and economic developments in those countries by simply saying stop lending.

Senator GRAHAM. Implicit in his proposal is that those who hold Third World debt would agree to the writedown between its nominal value and its marketplace value and in subsequent questioning Mr. Meltzer indicated that he felt that it would require actions by regulatory agencies in order to move private financial institutions towards such a proposal and would require some change in the method of asset accounting for the balance of their debt.

I assume that you would be a key figure in implementing those regulatory changes. What would be your response to those suggestions?

Mr. VOLCKER. Well, I think the description of the changes it would require suggest the difficulties—we'll arbitrarily change a few accounting procedures, we'll have to command them to write down the debts—I don't know how you do that—to market value. I assure you once you do that they will have a new market value that's less than the written down value. You don't sustain the value of the debts by writing them down and I have not thought that that's a very effective approach.

Among other things, by writing them down, I suppose you mean relieving the countries of paying the debt ultimately. Depending on how much you did it, there's a question of how much they would benefit in the short run.

What they need is an environment of growth, enough new money to maintain liquidity, and to pay interest, among other things. Sometimes, theoretically, you could, by not receiving the interest, provide the money. Are you creating an environment in which they can grow, return to the markets in the future, maintain open economies—these I think are the points at issue and they are very much at issue.

Senator GRAHAM. What's your assessment of the current policy—I would call the Baker policy—relative to Third World debt and its effectiveness in creating an environment of growth, particularly in the context of what is happening now in Brazil?

Mr. VOLCKER. There has been, viewed against history, some significant progress in Latin America in what I think are constructive directions of opening up their economies, reducing trade barriers, reducing distortions within their economies and, of course, that has accompanied a political opening as well. And I think it is quite promising.

And during this period, by and large, their external debt burdens have been reduced. But we clearly have a half-full glass and if you asked it from the other direction, are there lots of problems, there are clearly lots of problems. If you ask me whether the process right now has bogged down in inability to complete some financing programs for countries, I would have to say, yes, that is true in quite a number of countries, and that is threatening to the whole process I'm very much supportive of.

Now Brazil has a special kind of problem. What I am referring to in bogging down of some of these financial programs relates to countries basically that have an economic policy and have been proceeding broadly in the right direction. There are financing programs that have been negotiated. Brazil is in a grave economic crisis right now. They took some constructive steps earlier in the year. They had very rapid growth for a while. They were extremely competitive, which is, I think, good overall internationally, but in recent months inflation has resumed, confidence has been lost to a considerable extent, and their trade position has deteriorated.

That all obviously affects their financial position and their ability to raise money and the Brazilian situation is in a very difficult stage right now after a brilliant performance for a couple of years.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

Mr. Chairman, I want to return to the debt problem and the debt problem for the consumers, for the corporations, and for the Federal Government. I think on every front your monetary policy has been driving us into further debt. Let me tell you exactly why.

As interest rates drop—and I realize it is unpopular for interest rates to do anything but drop, but as interest rates drop, what do they do? They provide a diminished incentive for saving. If you save, you get a lower return.

As interest rates drop, you also have an increased incentive to borrow because you can borrow at a lower cost.

Now while that's not the only element, it seems to me it's a clear, decisive, objective measurable element. And therefore, I think that when you criticize—and you properly do criticize the Federal Government for running such an extraordinary deficit, one reason is because we have a lesser incentive because interest rates are low and we can borrow cheaply.

If interest rates were higher, the cost of the debt would be an even more spectacular and a discouraging element in our letting the deficit go up.

So I think we can't escape from that effect of monetary policy on debt. We've had a spectacular drop in interest rates over the past few years. Lots of other elements and all the urging you get from the administration, from 99 percent or 95 percent of Members of Congress is keep it up, keep those interest rates down; when you do

anything else you get denounced. The American people feel the same way.

But I think we have to recognize that that's the price you pay. You're going to have a lesser incentive to save. You're going to have a higher incentive to borrow for the Federal Government and for consumers and corporations.

Mr. VOLCKER. I don't think the evidence is that it very much affects the savings rate, but leave that aside—you can argue it moves in that direction, but I accept your general point that declining interest rates or more money facilitates growth of debt among other things. Whether that's appropriate or not depends upon all the surrounding economic circumstances. And I have tried to describe our dilemma in that respect.

I note in my statement that that is a potential problem, but we have to reach a judgment with some view toward that but with some view with what's going on in the real economy, what's going on in inflation, what's going on in other dimensions.

We reached particular judgments last year. They may be right or wrong. We thought they were right and I continue to feel that they're right. But the consideration you mention is one factor in the equation.

The CHAIRMAN. Well, I appreciate that and I only mention it because I think it's been ignored. I think all these other factors have been discussed and almost nobody discusses the effect of lower interest rates in encouraging borrowing.

Mr. VOLCKER. Well, I don't know about on the Treasury borrowing.

The CHAIRMAN. No, no, but it's encouraging consumer borrowing and corporate borrowing.

Mr. VOLCKER. There's no question about that and I explicitly say so in the statement.

The CHAIRMAN. And, of course, consumer borrowing and corporate borrowing is far bigger than Federal Government borrowing.

DANGEROUS AND UNWISE POLICY

Let me ask you this. Essentially your excuse for letting M1 grow so rapidly is that the public wants to hold more money balances and the Fed decided to accommodate that demand. It seems to me that this is an extremely dangerous and unwise policy and here's why.

First of all, no one can predict very accurately what the actual demand is for money. But even assuming your estimates are correct, your actions over the last two years have built up a tremendous amount of liquid balances in the economy. Eventually, when the money demand function shifts, those balances are going to be spent.

Isn't it true that the exceedingly liberal supply of new money allowed by the Fed in 1985 and 1986 constitute an enormous inflationary threat to the economy. What happens when the public decides to spend all the money you've created? Will the Fed then actually contract the money supply by 15 or 17 percent or whatever it was that you expanded it by?

Mr. VOLCKER. Well, I think that would be rather extreme. I can't imagine the situation where that would happen, although it's theoretically possible. But I went at some length in my statement to make precisely I think the general point that you are making; that in other economic circumstances—and I attempted to describe them—a very sharply lower growth in the money supply would be appropriate, precisely because of all the reasons you suggest.

The CHAIRMAN. Well, I read your statement carefully. I didn't get that emphasis, but I'm glad you're giving it to us now.

Mr. VOLCKER. Well, I refer you to page 27.

The CHAIRMAN. I'm sure it's there. I don't doubt your word.

Mr. VOLCKER. I don't think it's a part I skipped over under your urgings, but I ——

The CHAIRMAN. Let me pursue this in a different way then.

Mr. VOLCKER. I just want to point out page 27 and commend it to your attention.

The CHAIRMAN. What page?

Mr. VOLCKER. Page 27.

The CHAIRMAN. All right.

Mr. VOLCKER [reading].

> To the contrary, action to reduce the rate of growth of M1 promptly and substantially would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally.

The CHAIRMAN. Of course, that raises another question. It's never the time, you know. We had somebody yesterday say the way you avoid this kind of a situation we're getting into is never get drunk. And another way to do it, the way we're doing now, is to never be sober. If you're never sober, you never have a hangover. It's a hair of the dog that bit you, get another drink in the morning and you're good for the day.

Mr. VOLCKER. That's not my vision.

The CHAIRMAN. Well, I'm glad you don't follow that policy. Neither do I. But it's sometimes a tempting policy.

At any rate, let me ask you this. Over the last 12 months the money supply as measured by M1 has grown by 15 or 17 percent, depending on how you measure it, well in excess of the Fed's targets. That explosion in money growth is sometimes blamed on financial deregulation and lower interest rates. That is, as interest rates come down, people shift their money from short-term liquid investment into NOW accounts.

However, the demand deposit component of M1 has grown by nearly 13 percent over the last year. Of course, demand deposits pay zero interest.

As a result, why wouldn't it be accurate to conclude that the explosion in money growth is due to the Fed's decision to supply more money rather than an increase in the public demand for money?

Mr. VOLCKER. Well, it takes both sides of the supply and demand equation to produce the result, and we supplied the reserves. But demand deposits are also affected by declines in interest rates, by at least two avenues. I'll add a third avenue. It's true they pay no interest, but most demand deposits these days are held by businesses, many of them in compensation for services provided by the

bank. When the interest rate goes down, the bank says to get the same income I need a larger deposit because their return on that money has gone down.

These explanations are not alternatives. They go on at the same time. The fellow who is managing his demand deposit account isn't going to manage it so carefully when the reward of taking the money out of the demand deposit and putting it in something else is reduced. And this shows up in equations over a period of time.

So the direction of the movement is not at all unusual. The size of the movement is unquestionably unusual. The size of the interest rate decline was pretty unusual, too.

In part, you may have here a phenomena of whereas more demand deposits are held by businesses—that is, a bigger proportion of demand deposits are held by businesses—and banks are all sharper on their costing, so you may get more responsiveness to this compensating balance phenomena that I referred to than you got earlier when a lot of individuals held demand deposits and banks and their customers may not have been so precise in their calculations. That's speculation on my part. But the direction of the tendency is clear.

The third factor which is somewhat different, you have already mentioned—the obverse of that anyway. There are so many financial transactions going on which in the immediate sense may require some demand deposits to lubricate, that tends to pull up deposits, too. There is one type of financial transaction which has been very active, the settlement of mortgage-backed bonds, that requires explicit putting of demand deposits in escrow for a while, and that activity is so big it probably has some impact.

You saw this very clearly at the end of the year. This was—I don't know whether disturbing or comforting, depending on the way you look at it. There was an explosion in credit demands at the end of the year for a variety of reasons, including tax law changes, and there was a very large increase in demand deposits and the money supply generally at the same time. You had as much increase in the money supply around the turn of the year as we ordinarily get in a year and it was clearly related to an explosion in financial activity. Most of that has washed out. The increase in the money supply in February is going to be very small it looks like, and you've had a relapse from that explosion around the year end.

But that more persistent pressure from financial transactions is in there someplace. I don't think it's the major cause of the rise, but it is a third factor to put together with the others.

FOREIGN EXCHANGE VALUE OF THE DOLLAR

The CHAIRMAN. I'd like to ask you a question about the trade deficit. On page 18 of the monetary policy report that accompanies your testimony the Fed says that the foreign exchange value of the dollar has declined about 40 percent against a weighted average of the currencies of the other G–10 countries since February of 1985.

But on page 18 of that same report, it's noted that since early 1985 the dollar has appreciated in real terms relative to the currencies of Canada and some developing countries which account for

almost half of the U.S. nonpetroleum imports. In other words, we are not benefiting from the dollar decline in relation to those countries with whom we do almost half of our trade.

Mr. VOLCKER. Did it say that?

The CHAIRMAN. I notice that the Dallas Federal Reserve Bank——

Mr. VOLCKER. I hope our report didn't say that last sentence. You said that we didn't——

The CHAIRMAN. No, no. I said that we are not benefiting from the dollar decline with those countries with whom we do almost half of our trade. That was my conclusion. Your quotation is "Since early 1985 the dollar has depreciated."

Mr. VOLCKER. Your conclusion I think is wrong, and I just want to note that.

The CHAIRMAN. Well, all right. What puzzles me is that the Dallas Federal Reserve, a branch of your operation, said that if you have a comprehensive weight, including Canada and the developing countries and so forth, that the dollar has depreciated 5 percent, and that seems to be a far different situation than the 40-percent decline with respect to Japan and Germany and the 30 percent with respect to Great Britain, for example.

Mr. VOLCKER. Yes, that would be quite a different situation. I am aware of the Dallas Federal Reserve's calculations. I have told them I think that they are unrealistic and misleading in terms of the economic situation. They are well aware of my view on this subject. I do not think it's a good index and I'll tell you why.

It's the same observation you made. It's just nonsense to look at an exchange rate for Latin America or most of these countries before allowing for changes in prices. In the exchange rate itself, we have appreciated enormously against most of those currencies because they're having great big inflations.

Even if you put it in real terms, the implication that we do not benefit in trade terms with those countries from the change in the exchange rates among the industrialized countries is simply wrong.

If you have no change in the exchange rate vis-a-vis the Korean won, but our exchange rate has changed 50 percent against the Japanese yen, obviously the Koreans now have an enormous incentive to export to Japan instead of to us and to import from us rather than from Japan. And that's the market that is supposed to work.

It doesn't make any sense for a country—take Canada—that Canada does not have a current account surplus. They have not been in a position—I'm just speaking very generally—for a major appreciation of their currency, but they certainly now have more incentive to export to Europe and Japan and less incentive to export to us and our market as a market from which to import is certainly more attractive now than it was two years ago relative to Japan and Europe. That's what these exchange rate changes are all about.

Now the difficulty is that the effects may be greatly slowed down or thwarted if Japan in fact refuses to import from Korea or the Europeans don't open their markets and then these financial incentives don't work. But that's not an exchange rate problem. That's a trade problem.

The CHAIRMAN. My time is up. Senator Heinz.

Senator HEINZ. Chairman Volcker, I wasn't going to talk about trade, but since you left Senator Proxmire on that note I will just ask you one quick question on trade.

PROTECTIONISM

This goes back to the subject of how we avoid protectionism in this country and maybe some semantics on the subject.

Many of us are persuaded that the only way that we can get countries to open their markets to us is to threaten or perhaps go as far as to deny, until such time as other markets are opened to us, access to this market. It is no coincidence that this country accounts for roughly 22 or 23 percent of the free world's aggregate gross national product and we accept 50 to 60 percent of the free world's merchandise trade as imports.

My question to you is, is it protectionist for the United States to have a law that in effect says we will deny a particular country or particular sectors of a particular country market access until that country removes the trade barriers that are denying us access—probably as a practical matter in different sectors—is that protectionism or not?

Mr. VOLCKER. I think you're asking me a semantic question that I find difficult to deal with.

Senator HEINZ. I don't know whether it's semantical or not.

Mr. VOLCKER. I think there's a real issue here, don't mistake me, but I think you would say if you put up a trade barrier that's protectionism, whether it's for a good purpose and for the purpose of trying to get somebody else to reduce their trade barriers so that the total in the end will not be protectionist——

Senator HEINZ. Let me help you a little bit with semantics. I would argue I think as a scholastic matter that protectionism, as defined, is to protect an industry and that if you're going to protect an industry in this day and age you had better have very broad comprehensive trade barriers affecting every country.

Now the President has a steel import restraint program in effect on steel. It isn't working too well because there are just three countries out of about two dozen—Canada happens to be one of them, Sweden and Taiwan until recently—that simply weren't participating and, as a result, it hasn't had the effect the President wants it to have.

So my argument would be, if you're picking on a particular country with your retaliation that it is probably not protectionistic because there are so many sources in this day and age of substitute products and, therefore, I really don't see your semantical problem.

Do you still see it after that explanation? Have I given you cause for hope and light?

Mr. VOLCKER. I don't think the real problem is what is semantics. The problem is whether, in the interest of a greater good, as you describe it, in breaking down the trade barriers of others this is an effective, efficient, understandable technique. And in some particular instances it may be. I certainly understand the frustrations that underly that approach.

I would think also if it's clear enough, you could get multilateral support for that effort and that might be a test.

Senator HEINZ. Let me return to a subject I wanted to pursue with you originally and that has to do with the overleveraging of the economy. Many of us today have heard you and others talk about high burden of consumer debt, the national debt, the debt we owe other countries, corporate debt, and the jury seems to be in that we are overleveraged and that entails a number of risks to our economy. Is that right?

Mr. VOLCKER. Well, I, unfortunately, don't think you can say the jury is in. A lot of Wall Street doesn't seem to think so. I understand it's a badge of honor these days not to have——

Senator HEINZ. Well, as a jury of one sitting down there, what do you think?

Mr. VOLCKER. I think we are in danger obviously of moving too rapidly in that direction. I have no doubt about that.

Senator HEINZ. To what extent do you believe the Federal Government's policy of insuring financial institutions against risk is a contributing—not maybe the determining factor but a significant contributing factor? Is it or is it not accurate that by providing deposit insurance—and I'm not necessarily arguing against it, but just to understand the effect—that by providing deposit insurance, we guarantee that institutions, some of which will take bigger risks than others, will have access to funds and, therefore, by having that kind of policy, we perpetuate risk-taking through a government policy? Is that a fair statement? Is that accurate or have I missed something?

Mr. VOLCKER. I'm afraid I would get maybe semantical and say we're not insuring the institution, and many institutions are failing, as you know. But we are protecting depositors through the FDIC and through other events, and I don't think there is any doubt that in some circumstances that protection which enables institutions to raise more money more freely than would otherwise be the case may contribute to risk-taking, excessive risk-taking.

Senator HEINZ. Among banks or among S&L's, don't we insure deposits for the same cost, irrespective of the policy of lending of the particular institution?

Mr. VOLCKER. Of the individual one, yes. Of course, as you the know, the S&L's now pay a premium.

Senator HEINZ. And so we have the Continental Illinois Bank. I seem to recollect that we did a little rescue operation there.

Mr. VOLCKER. I think you've got your hands on a real problem. I have not thought that the way to handle this ideally is by risk-based premiums, if that's what you're getting at. But I have no doubt in my mind you've got a problem.

Senator HEINZ. I'm getting at—since I think we both understand there can be difficulties with risk-based premiums, I'm looking for a way to address the problem. Because if it's true that we are overleveraging ourselves and putting ourselves unnecessarily into a dangerously risky position—we may not be there yet, but we can see the tunnel at the end of the light. We ought to be doing something about it rather than just talking about it.

Mr. VOLCKER. Well, I obviously can't disagree with that. Now this insurance only goes to depository institutions—commercial

banks, and savings and loans, leaving out credit unions for the moment, which are not a source of the problem. That is an area of the financial community that we otherwise regulate and that is part of the balance. They do get the benefits of insurance, but we're supposed to be supervising them, collectively and not just the Federal Reserve. And the supervision is supposed to obviously be alert to precisely the kind of developments that you're talking about.

A lot of the leveraging in the economy is going on outside these institutions—not entirely, but in good part outside the areas that are technically covered by deposit insurance.

Nonetheless, I think you have your mind on a problem that needs to be dealt with.

I would say the other side of that is we've got to proceed very cautiously in this area, given the existing strains that are evident on many financial institutions.

Senator HEINZ. Chairman Volcker, your admonition as to caution is well taken. I don't quarrel with that. I can't help but reflect, however, that our solution to the problem you and I have been discussing is that next week we're going to hold a markup in this Committee to approve a $12 to $15 billion bailout of the Federal Savings and Loan Insurance Corporation. What we are doing is, in effect, just keeping a system afloat——

Mr. VOLCKER. I agree.

Senator HEINZ [continuing]. That has all kinds of—is leaking desperately and badly. And there's no institutional reform. All we're doing is we're putting more of the taxpayers' dollars beyond the premiums that that particular industry has contributed, and we have a great, wonderful and fundamentally phony way of doing it so that it doesn't show up on budget, but make no mistake, there are going to be $12 to $15 billion more allocated to the FSLIC and, correspondingly, less will be available elsewhere.

So this is not an academic question.

Mr. VOLCKER. I agree with that fully and I have urged before and I will again that I think this whole problem that you're raising now should be addressed by the Congress. I think it has to be addressed with great care and deliberation, but I certainly hope that will be on your agenda for more comprehensive legislation when you get this immediate question out of the way.

Senator HEINZ. That is a critical point.

Mr. VOLCKER. What's a critical point?

Senator HEINZ. Do you say to a fellow who is drowning, "I'm going to give you a life preserver and drop you off back out in the middle of the ocean and see how long that keeps you afloat," or do you tow him into shore and show him what dry land looks like and teach him to walk again?

FSLIC BAILOUT

The problem I have with simply passing an FSLIC bailout bill is all we do is tow these people back out in the middle of the ocean and see how long it is they can stay afloat out there without making any provisions either to lower the water level or to teach these people to swim or walk.

Mr. VOLCKER. Well, what people are you talking about, the FSLIC?

Senator HEINZ. The FSLIC.

Mr. VOLCKER. Well, I think you are certainly throwing them a life preserver if you're talking about the FSLIC. I think that that is essential under current circumstances. This plan, as you know, is basically——

Senator HEINZ. But what you're saying is don't do anything about the basic problem, wait until later. How long do we have to wait?

Mr. VOLCKER. I don't know, but I think a lot of difficult problems arise here that have to be carefully considered and you sure have got to wait more than a month or two, and I think the time plan you have for this program should be in the framework of a month or two, but I am not discouraging you from getting to work on the other problem.

I am urging caution and care because I think it is a very difficult, complicated problem. I think you ought to get to work on it. I have occasionally had some thoughts on the subject myself. I don't think you have to delay at all, and I don't think there has been any delay. I think there has been very considerable effort in the Home Loan Bank Board and the FSLIC to tighten up their regulatory and supervisory approaches, and I think that ought to be recognized. It's not quite that you're just throwing them this money and nothing has been done. Quite a lot has been done over the last few years.

Senator HEINZ. Mr. Chairman, my time has expired. If I could have one additional minute, there's one followup question I would like to ask on this.

The CHAIRMAN. Go ahead.

Senator HEINZ. Virtually every economist and financial expert I've talked to has agreed with the proposition that nonbank banks, consumer banks, the creation of those, is a direct threat to the S&Ls. They syphon off deposits. Now I don't think it is actually fair to say that tying a closure of the nonbank bank loophole to FSLIC is actually plowing brand new turf.

We passed legislation to do that about 3 years ago in the Senate. Now are you saying that we shouldn't, at the minimum, do that?

Mr. VOLCKER. Quite the contrary. This issue arose before and I really think, as I said before, the failure to act in that area is an abdication. I think it has the effect that you're talking about, but I think it's a much broader issue.

I was interested in noting in some newspaper column this morning people upset with the grandfathering and tandem restrictions that Senator Proxmire put in the bill. They said, "My goodness, that's what it is all about. We want to cross-market all these services with our commercial firm." And, of course, that is just the issue. What kind of a banking system do you want? Do you want a banking system that's primarily devoted to cross-marketing the services of Sears Roebuck, Ford, Chrysler, and all the rest with all the problems that arise, or do you want an independent banking system?

Senator HEINZ. So it is your strong view, as I understand it, that we should address those issues as part of a FSLIC recapitalization.

Mr. VOLCKER. On that issue, it is my very strong view you should address along with it that issue of those particular securities powers that the Chairman has put in the bill. I think it would be a dereliction if you don't deal with those issues at this time.

Senator HEINZ. Mr. Chairman, thank you.

Senator Sarbanes, I thank you. You were kind enough to delay your time.

The CHAIRMAN. Let me just say that I'm going to have to leave and, Senator Riegle, if you'll take over as Chairman in my absence.

Senator SARBANES. Chairman Volcker, I wanted to follow along a line of questioning that Senator Heinz put to you and I thought put very well on this protectionism, and I think the one agreement I got out of all of it is that it really is a matter of semantics. I mean, various proposals for looking at this thing are brushed away by a lot of people by trying to stick that label on it, and then you can't in a sense come to grips with it.

Mr. VOLCKER. If I may just interject, I think you could call that a matter of semantics. He put a very limited question, a specific restriction, with the clear and single objective of getting the other country to remove a restriction.

Senator SARBANES. Well, that's right. And I want to turn to pages 11 and 12 of your testimony where you talk about Taiwan and Korea, where you've been, in effect, so bold as to actually pick out a couple of countries.

What approach is there other than the one Senator Heinz suggested to move these countries to deal with what you have termed a strong wall of protectionist barriers? As long as they can go along as they are, it's very much to their advantage.

Mr. VOLCKER. Well, it's not entirely to their advantage and one would like to think that reason prevails at times, although I recognize that they're very—it's not to the advantage of particular industries that are being protected in those countries.

Just how that is dealt with—and you're really going to get outside an area where I think I can be very helpful. I'm not an expert—maybe I shouldn't have mentioned Taiwan and Korea, but that involves a lot of negotiating considerations and a lot of facts that I may not be familiar with.

I can understand that what Senator Heinz was talking about is one possible approach in particular selected instances.

RESPONSIBLE ECONOMIC CONDUCT

Senator SARBANES. Don't you think it's reasonable to assume that it's unlikely they are going to take forceful action to increase imports, whether by reducing tariffs, lifting other trade restrictions, or by exchange rate changes, all of which of course suggest that you think their performance in those three areas fall short of responsible economic conduct—on tariffs, trade restrictions, and exchange rates.

Mr. VOLCKER. My sense is that they will and are doing something and I don't know what word I use there—I have great doubts that it's going to be sufficiently forceful. I think they are taking action.

Senator SARBANES. If they perceive that their access for markets for their exports were going to be affected, it might move them

rather quickly to address these three items to which you make reference.

Mr. VOLCKER. That is one possibility, but those kinds of actions and threats have dangers of their own which you have to take into consideration.

Senator SARBANES. That's right, but none of the other possibilities seem to have worked.

Mr. VOLCKER. Well, I am not ready to make that sweeping judgment, but I understand.

Senator SARBANES. Which leads me to my next question. You preface that paragraph by saying, "Some newly industrialized countries also have clear responsibilities for contributing to a better world balance."

My question is somewhat broader than that. Is it your view, given the strengths of various national economies, that there are a number of countries that are not assuming their international responsibilities in terms of contributing to a better world balance that's commensurate with the strength of their national economy?

Mr. VOLCKER. Well, clearly, when you're talking about the imbalance related to trade or current accounts, you look around. We've got a big deficit. We are one of them on the deficit side. Germany, Japan, Taiwan, and Korea—Taiwan stands out more frankly than Korea. It's a little country with an enormous trade surplus and enormous reserves already accumulated. But then I think you have to look further and say, are they contributing or not depends upon their internal economic situation. Are they growing? Are there areas where they are reasonably falling short or not?

Now I would say in the case of Taiwan and Korea, as I stated, that you look at those countries and their strength externally has been growing. They have room to move much more aggressively on their trade barriers now than they would have had 5 years ago.

Senator SARBANES. Let me ask about Japan and West Germany, two major industrial countries who are running very large surpluses.

Do you think that a new and broader perception needs to be developed on their part in terms of their responsibilities with respect to the international economy?

Mr. VOLCKER. Well, I think the whole effort of the administration and others has been to move clearly in that direction and I think there is a better appreciation now than perhaps a few years ago. Indeed, you see—for that reason or otherwise, you see some results. Both of those countries, at least in relative terms, have had a better expansion and internal demand and some decline in their real net exports last year. That is a direction in which things I think must move and that is the direction in which things did move last year to some degree.

Now one can sit here and say, as I would, that given the overall growth rates in those countries, given the amount of resources they have that are unemployed, the availability of capital and so forth—is the rate of movement optimal?

Senator SARBANES. What about their responsibilities, given their surpluses, to move capital into the Third World and contribute to the possibility of the Third World being able to go on to a growth pattern? That's traditionally a responsibility the United States has

tended to assume in the post-war period. We're not in a posture to do that and, in fact, our trade deficit, if you look at it, where it has worsened most noticeably in many instances it's with respect to trade in the Third World, which before was always an offset against the deficits we were running with these very industrial countries.

Now given their surpluses and their strength, why shouldn't they have a responsibility to circulate some of that to contribute towards Third World growth?

Mr. VOLCKER. Well, in some kind of broad concept, that would be very helpful to see much more capital flowing from those countries to Third World countries, let's say, and we earn it back in trade instead of borrowing it ourselves. This is what it would amount to and that would be a nice outcome.

In practice, I don't think you can say those countries officially—and I haven't looked at it recently in detail—are probably doing any worse, they are probably doing better than we are relatively in terms of sheer official aid.

And when you talk about a kind of grand conception that you have of much bigger flows of capital out of those countries, you run against a problem that those capital outflows they have are essentially in private hands, and how do you redirect a private flow of capital? That basically depends upon perceptions of market incentive.

For the government to redirect it in the kind of billions and billions of dollars that you're talking about, the taxpayers in those countries and the budgets in those countries would be taking on the burden. And on the scale that you're talking about—I'm not talking about the direction, but the scale that you're talking about—I think it's simply unrealistic to think that Japan with a surplus of whatever it is—$60 or $70 billion—is going to appropriate $30 billion for aid to Latin America rather than some proportionately small amount.

I just give you a practical judgment. However desirable that may be, it ain't going to happen.

Senator SARBANES. What about trying to get them to work multilaterally to accumulate resources from a number of places and, second, so that they don't tie the aid. I mean, Japan moves forward now and says, "We're going to meet our responsibility." Then they have a bilateral flow and then they tie it, which simply worsens the trade problems.

Mr. VOLCKER. Those comments are very relevant. There are both some progress and some work going on, and I think it's a very relevant comment.

Senator SARBANES. Thank you.

Senator RIEGLE. Thank you, Senator Sarbanes.

Mr. Chairman, three topics. You've been here quite a while and I don't want to keep you too great a length.

UPCOMING G–5 MEETING

Regarding the upcoming G–5 meeting, for our goals to be achieved, many of which you've talked about today, it seems to me the economies of those other nations have to grow and I'm wonder-

ing what kind of growth rates you and Secretary Baker might have in mind.

For example, West Germany, would we be thinking of maybe a growth rate of 3 or 4 percent, something in that range; and with respect to Japan, are we thinking about something like 4 or 5 percent? Where are we in terms of what it takes to make the system balance here?

Mr. VOLCKER. Well, those growth rates would be very nice, but I don't want to set out a particular target. I think obviously I have some concern at least—and Secretary Baker is perfectly capable of speaking for himself—that those growth rates, particularly the growth in domestic demand, while in relative terms it has been improving, I would feel a lot more comfortable about the world situation—I would feel a lot more comfortable about the speed of these international adjustments, if it were growing more rapidly.

The latest evidence in those countries tends to be on the side of flattening growth rather than speedy growth.

Senator RIEGLE. When you say the latest data, you mean within the last say quarter?

Mr. VOLCKER. Yes.

Senator RIEGLE. So growth may be slowing down in Japan and in Germany?

Mr. VOLCKER. Well, in Germany in particular, the figures definitely show a slowdown. Now you can get into all the arguments about seasonal, whether it's been a bad winter and all the rest. In Japan, I don't think they've slowed down particularly in the last few months, but it's not a very vigorous growth rate—2.5 percent or something, as I remember, which is way below Japanese standards.

So what I'm saying is that in these recent months I think within those countries more questions have been raised about the adequacy of their growth rate than earlier. I share that concern.

Senator RIEGLE. Well, that's really the point of my question. In terms of balancing the international trading and financial system, you have testified here before that we are now interconnected in ways that we might not have been in years past and that's it's very important that we get corresponding adjustments that fit together. So I guess you're saying that you feel that the whole system would be better off if we could get higher rates of growth in both those countries than we are presently seeing?

Mr. VOLCKER. There is no doubt about that. Now in saying that, they are going to say, "Well, don't forget, we want to safeguard our internal stability, our prices," which I have great sympathy with. I think that could be managed. They also say, "Yes, but this is a two-sided process and where is your adjustment? And you don't give us very encouraging signals about your budget deficit and we think this process ought to start with reducing your budget deficit."

Well, I don't know where it should start and where it should end. They both have to be done, but I do think, as I said in my statement, that without them having some feeling of confidence that the United States is moving forcefully in the right direction it saps their will to take what they see is equally politically tough decisions to move in the other direction.

And we both ought to be moving, in a sense, in opposite directions. That's what would make for the international consistency I think in dealing with these adjustment problems.

Senator RIEGLE. Well, you properly I think point out the role of our federal fiscal deficit. Last year it was the highest in our history, $221 billion, and maybe it's going to be substantially below that for this fiscal year that we're now in. We hope that it will be, but we won't know until all those numbers are in.

I agree with your emphasis on that, but so much of the time you seem to leave out the trade deficit and the trade deficit is running at $170 billion at the same time. It seems to me that we have to move on both those problems and they're connected to one another and we've got to make progress I think very rapidly on both. Isn't that correct?

Mr. VOLCKER. Yes, that is correct, and I don't think you're going to make progress on the one without making progress on the other.

Senator RIEGLE. Well, that comes back to Japan. With respect to Japan, if you look at our trade deficit last year, $170 billion, the Japanese figure in terms of their surplus with us was, according to the Commerce Department, about $59 billion, by far and away the largest single part of that $170 billion deficit. And without repeating all of the litany of factors, you know that the Japanese are very skillful at keeping our products and other nations' products out of their markets and so the trading system is not open both ways.

Isn't it also necessary that if they're going to expand their internal economies that something has got to be done about these incredible bilateral deficits with countries like Japan? You mentioned Korea and Taiwan and I think properly so because those are now persistent problems that are in the multibillion dollar range—about $16 billion last year with Taiwan alone. But isn't Japan going to have to find a way in their bilateral trading relationship with us either to buy more or send less so that we get this deficit down from an area of roughly $60 billion a year?

Mr. VOLCKER. Well, obviously, their surplus with us is enormous and it's very hard for us to see us dealing with our general problem without a reduction in that deficit. But I think that's the wrong focus to look at it in. I think the world trading system—maybe less so—but nonetheless is still a multilateral system and where the individual bilateral deficits fall out I don't think is so significant.

What matters is their overall surplus. That's what I would emphasize, their $70 billion overall surplus, and our overall deficit, rather than the bilateral one.

As I indicated before, it would be greatly in our interest, as Senator Sarbanes was illustrating on the capital side—but just on the trade side, if they absorbed a lot more imports from Latin America, that would give Latin America the capacity to import a lot more from us and might not affect our trade balance directly with Japan at all but it would be a remarkably constructive contribution to their overall surplus and our overall deficit.

Senator SARBANES. Would the Senator yield?

Senator RIEGLE. Yes, I yield. By the way, I think that's an important point.

Senator SARBANES. Provided that Japan didn't tie taking more imports from Latin America to Latin America taking Japanese exports, which of course they tend to do.

KOREAN EXPORTS

Mr. VOLCKER. I agree, which would be inconsistent with our exports rising. You just mentioned Korea. Korea, of course, is right next to Japan and I read in the newspapers anyway that Korean steel is now pretty competitive in Japan and it's pretty competitive in the United States too, I guess. But it must be, given these exchange rate changes, a very considerable incentive—just to pick out one product—cars—to sell them to Japan. But if Japan isn't going to take them, that process is thwarted. It's not a trade barrier against us. It's against them.

Senator RIEGLE. Well, it's not only thwarted. What happens is, is that steel then basically comes to the last big market that's left, and that's here. And just with respect to cars—and cars, of course, contain a lot of steel—if you take the Hyundai, which is a very popular new Korean import, they are planning to ship about 200,000 of those in here this year but their goal 3 years down the line and their production plans in Korea are to produce and ship in here roughly 1 million cars. And it's an enormous fact of life, not just for that sector of the economy, but that is a pattern we're seeing way beyond steel and cars.

Mr. VOLCKER. Well, I understand that and I suspect that those plans were made and developed over a period of time and against competitive positions that existed in part some time ago.

The logic of the exchange rate changes we've had is that they should be thinking of exporting more of that planned million or whatever it is to Japan or to Europe or elsewhere and less here.

Now whether that works, of course, is related to your comment—if we're the only open market, that process doesn't work.

Senator RIEGLE. Well, I want to tie down two other things on this because it's important and your testimony is important.

As I understand it, even though the dollar has come down substantially against the yen over the last year, we really have not had any major change in currency value between our currency and the Korean currency. Is that right?

Mr. VOLCKER. That's correct. I think there's been some appreciation but not much.

Senator RIEGLE. I think less than 1 percent.

Mr. VOLCKER. Well, I'm not sure about that, but it's small anyway. I will accept your statement. It's negligible.

Senator RIEGLE. Here's the point. Some will argue that what's going to happen here with the 40-percent decline of the dollar versus the yen, is that over a period of time after a lag, you'll start to see some adjustments in the trade situation unless there are just naked barriers that prevent that from happening.

But with respect to Korea, if changes in currency value are not reflected in any differential way between the two countries, it seems to me we're not going to get that kind of effect in six months or sixty months.

Mr. VOLCKER. Well, I think that's just plain bad economics. Abstracting from the trade barriers, which are very real, but just looking at the currency values, the change in relative currency rates between the United States, Europe and Japan gives Korea more incentive to export to those countries and to import from the United States without the dollar-won exchange rate changing by 1 won, or whatever the rate.

Senator RIEGLE. Well, that's if they can get in those markets.

Mr. VOLCKER. If they can get in them, that's right.

Senator RIEGLE. But if they can't get into the markets, then they come back.

Mr. VOLCKER. If they can't get into those markets, that process does not work and then you've got another set of problems.

Senator RIEGLE. Two other things quickly. Citicorp seems not to want to make further loans to the LDC's at this point. At least they seem to be the one bank that is the least enthusiastic about doing so. That's what the stories say.

Mr. VOLCKER. Well, the stories don't say that—just to be clear—I don't want to comment about an individual bank, but I think the stories focus on questions about what the interest rate should be, not whether they are willing to lend or not.

Senator RIEGLE. I'll accept that correction. I think that's a very important point. It sounds to me as if they don't have much enthusiasm for wanting to lend at the rates that maybe they're being encouraged to lend at. Is that a fair summary?

Mr. VOLCKER. Well, I don't know what's being encouraged or discouraged. It's a question of negotiations between the countries and the lenders.

Senator RIEGLE. Well, let me ask a very direct question. Will the Fed pressure any of the banks to extend or increase their loans to the LDC's?

BAKER PLAN

Mr. VOLCKER. We have made our feelings in this general area amply clear—I do practically every time I testify—about the overall interest that we see in this process moving forward under the broad rubric of the so-called Baker plan. It's always been understood that the banking community as a whole had certain responsibilities in that area if the plan was going to work.

I don't consider that pressuring the banks. That's making a point of view known and we do it pretty clearly when we're talking to banks in groups or when I'm talking in public I say the same thing.

Now that process has slowed down. It's bogged down recently and I think the atmosphere, for a variety of reasons, has undermined the atmosphere surrounding the whole initiative and many of these programs don't require new money. Some of them are just refunding, which are usually very simple—very simple is not the right description—but considerably simpler to implement than when you're asking for sizable amounts of new money.

But we've got a lot of—seven or eight countries that have been negotiating financing plans for months and none of them have been absolutely completed. Some of them are on the edge, but none of them have been conclusively completed.

This is a long and frustrating process and, obviously, I would feel more comfortable if that was moving more expeditiously.

Senator RIEGLE. One of the questions in my mind—and it isn't to take the argument or position of any private banking institution, but it seems to me that these loans are very much—they have a national interest component to them and it makes me wonder at what point, if banks are being pressured by events or pressured by our Government to either continue loans or extend loans or to give favorable interest rates, that if there's a public policy component to that, that maybe the Government itself ought to be extending those loans rather than go through the fiction that they are private sector loans and recognize that they are really perhaps public sector loans.

Mr. VOLCKER. Well, I don't accept that the loans that the banks made were public sector loans. They were pretty eager to get into that business at one point.

Senator RIEGLE. I'm talking about from here forward.

Mr. VOLCKER. From here forward, I think the United States and other governments, acting either bilaterally through export credits or otherwise, and certainly acting multilaterally through the World Bank and the IMF, have a clear responsibility to support this process and, in some cases, put up new money, which, of course, is what the World Bank in particular is doing now.

If you look at the Mexican program, which isn't quite tied up—it's one of those that's been caught—a very large program and a very difficult one because they were so hard-hit by the oil situation exclusively in terms of the size of the program, roughly half of the new money involved in that program comes from official sources—I think a little more than half.

Senator RIEGLE. Just one other thing and this is—I don't mean for this to be an overly provocative question to you. I'm trying to get a sense as to the margins we have right now in terms of managing our financial problems and we've got a whole laundry list—the Federal budget deficit, the trade deficit, the working out of multilateral arrangements, Third World lending and a host of other things—monetary policy, where that fits in. The question I have in my own mind in terms of how much margin we have and the parameters we're working within—if we were to see a recession of any consequence, say, over the next 12 months, would that come at a time that would be particularly worrisome in your mind in terms of navigating our way through all of these difficult problems?

Is it very important for us to stay out of a recession now? We never want one, but I'm asking the question, does it pose extraordinary dangers?

Mr. VOLCKER. I think the risks of that are inevitably greater to the extent the rest of the world is not growing on its own momentum with some strength, and I think the risks are inevitably greater to the extent that the international debt problem is still there, as it obviously is. I would think the risks grow over time.

I would take a somewhat different perspective if the financial system gets too highly leveraged. But the more questions there are in the world economic and financial system outside the United States, the bigger the problem potentially you have.

Senator RIEGLE. I would just finish by saying, when I try to think of what would happen if we started to slip into a recession, with the Federal budget deficits rising because revenues would fall and transfer payments would——

Mr. VOLCKER. If I may just interrupt, that's not the part of the budget deficit I would worry about. I mean, really when I'm talking about the budget deficit, I'm talking about reducing the budget deficit in the context of growth. Obviously, if you were in a recession, the budget deficit would be affected.

But what you've got to aim at is get that structural deficit under control.

Senator RIEGLE. Well, you make the point I was coming to and you were ahead of me, so I'll let your point stand.

Senator Sarbanes, you wanted to make an observation.

Senator SARBANES. I just wanted to get one final sort of reaction from the Chairman.

TRADING SYSTEM UNFAIRLY STRUCTURED AGAINST THE UNITED STATES

First of all, let me say I'm not trying to lead toward any conclusion or any way you go about redressing the situation I'm about to set. But there's a perception I think in the Congress and in the country that the international trading system is currently structured—is unfairly structured against the United States. In other words, we are being taken advantage of, that our market is much more open than other markets are to us. We had the whole problem of the currency valuation which put our producers out of business because of that problem.

We carry a heavy strategic responsibility, a defense strategic responsibility, so we have 6 percent of our GNP going into defense and other countries have much lesser percentage so we're carrying those broad responsibilities.

And that, in a sense, perhaps the United States is still operating on the premise that prevailed in the years after World War II when we were clearly the dominant economic power and, in many respects, I think made concessions to help the rest of the world grow, that that time has passed, that we're in a very different situation.

Now how you address it is a complicated matter and one of controversy. But what I'd like to get from you is whether you think the perception that the system is not now fairly structured, that the rules are not fair and need adjusting—and you can adjust them in lots of ways obviously—but whether that perception you think has some accuracy to it?

Mr. VOLCKER. I would not say the rules themselves I think. I sit here and think there is some truth to the perception that in fact, at least among the major countries, we are the most open market. We obviously have the biggest defense spending and I think those perceptions are accurate.

I'm not sure that they have changed dramatically. You say this was kind of built into the postwar system to some extent and if you take a long sweep—go back 30 years to the 1950's when we consciously almost unbalanced the system, I suspect it may be less unbalanced.

But nonetheless, I share the perception that, by and large, we have more open markets. We are more welcoming of imports, whether by governmental policy or culture or whatever, and that we do carry certain burdens that other countries do not carry. I agree with that, but I'm not so sure it's changed so much in recent—I don't think that's the explanation of why our trade balance is $150 billion worse than it was 4 years ago.

Senator SARBANES. When Secretary Baker went to the Treasury in February 1985, he moved pretty quickly to address—at least in my judgment pretty quickly—to address the currency overvaluation question because it was by that fall that he had the Plaza agreement.

I take it it's your view that, one, he needed to do that; and, two, that we had failed for too long to come to grips with that problem?

Mr. VOLCKER. Well, I certainly think that the dollar had gotten to extremely high levels and was overvalued. It had been declining for nine months before the Plaza agreement but that gave it further impetus. But I think it's very hard to see a more balanced trade pattern emerging without a substantial realignment of the major currencies. I agree with that.

Senator SARBANES. Thank you.

Senator RIEGLE. Thank you, Senator Sarbanes.

Thank you, Mr. Chairman.

The committee is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Response to written questions of Senator D'Amato from Paul A. Volcker follows:]

Chairman Volcker subsequently submitted the following in response to written questions from Senator D'Amato in connection with the hearing held February 19, 1987:

Question 1: Mr. Paul Craig Roberts contended during the hearings that unanticipated disinflation caused by an excessively tight monetary policy accounts for $459 billion, or 46 percent, of the one trillion dollar increase in the public debt over 1981-1986. If Mr. Roberts is correct and the Federal Reserve's monetary policy contributed to the budget deficit, do you have any suggestions on how the Federal Reserve may use monetary policy to assist in deficit reduction?

Answer: Characterizations of "unanticipated disinflation" and "excessively tight" money are, of course, uniquely those of Mr. Roberts and have no independent analytic value. In general, however, there can be no clear answer to a question of what the deficit would have been in more inflationary conditions. While one might assert that the spending and revenue programs actually in place over the 1981-1986 period would have produced a smaller cumulative deficit if inflation had been greater (and all other things, including real growth), that begs a lot of obviously important questions about how Congress would have behaved in a different economic environment and whether greater inflation would have been consistent with achievement of the favorable trends in real output, employment, and interest rates we experienced during the five year span. I strongly suspect that there is less than meets the eye to Mr. Roberts' claim.

Whether or not Mr. Roberts is correct in his claim, I believe that the way the Federal Reserve can best contribute to deficit reduction over the long haul is the same way that it can contribute more generally to healthy economic performance: by pursuing a monetary policy consistent with sustainable, noninflationary economic growth.

Question 2: Despite claims to the contrary, the Secretary of the Treasury seems to have determined upon a level to which he intends to drive down the value of the dollar. Do you feel that there is a yen/dollar exchange rate that is too low? What are the risks for our domestic economy if the value of the dollar is driven down too far?

Answer: Secretary Baker and I have agreed with finance ministers and central bank governors of other major countries that around current levels exchange rates are within ranges broadly consistent with economic fundamentals and basic policy intentions. Moreover, both Secretary Baker and I have said that a further decline in the dollar in the present circumstances could be counterproductive. It would tend to weaken economic activity abroad, by reducing demand for their exports and consequently by discouraging investment in new productive capacity. In this country, it could pose substantial risks of renewed inflation momentum and undermine confidence in future financial stability--developments that could jeopardize prospects for a sustained economic expansion.

Instead, we should recognize that the favorable impact on our external position of the considerable decline in the dollar we have already seen will be fully realized only with a lag. We should, in the meantime, act to reduce further our federal budget deficit--while other countries provide stimulus to their economies--in order to create the domestic conditions that will accommodate the adjustment in our external position without the pressures on prices and interest rates that might otherwise occur.

Question 3: One of the witnesses suggested during the hearings that the dollar's decline has resulted in the Federal Reserve feeling pressured to raise interest rates "to save the dollar" and forestall a renewal of inflation due to rising import prices. Is this a correct assessment of the Federal Reserve's feelings? If the Federal Reserve were to succumb to these pressures and raise interest rates, could not this have a recessionary impact on the economy?

Answer: Developments in exchange markets have been for some time among the factors considered by the Federal Open Market Committee in its monetary policy deliberations. That is because exchange rates do have implications for the U.S. economy.

We have already experienced a substantial decline in the dollar's value, and I believe in current circumstances a further sizable depreciation of the dollar could well be counterproductive. Officials in other countries share that view, and large-scale intervention has been undertaken to support the dollar. But in the end, confidence in the current exchange rate levels will depend upon perceptions that more fundamental policies will in fact be brought to bear. I have emphasized the need for complementary changes in fiscal policies in the United States, Germany, and Japan. The conduct of monetary policy, here and abroad, will be relevant as well, and the performance of the dollar in the exchange market might become a factor bearing on our provision of reserves. There could be circumstances in which the Federal Reserve could act to restrain the supply of reserves to resist the dollar's decline. Those

circumstances are more likely to be associated with excessive pressures on resources and a greater risk of inflation than with a recessionary situation.

Question 4: During the hearings, one of the witnesses suggested that the current Gramm-Rudman deficit reduction targets should be abandoned or ignored. Do you think that the Gramm-Rudman targets should be abandoned? What would the consequences be of our failure to realize these reductions on interest rates and GNP growth?

Answer: Enactment of the Gramm-Rudman-Hollings Act had a positive effect in financial markets as it bolstered confidence in the ability of the government to bring order to its finances and led to expectations of reduced pressures in credit markets from Treasury borrowing. Simply abandoning Gramm-Rudman-Hollings thus would appear to entail some risk of damaging sentiment. At the same time, though, I believe analysts recognize that hitting the statutory targets exactly is not what is required to solve our fiscal problem. For example, a failure to hit the prescribed number in some year might not be especially dismaying if significant action had been taken and the miss resulted from deviations of the economy from reasonable assumptions used in the budget projections; on the other hand, success in hitting the target in a particular year would not be impressive if it were achieved largely by accounting legerdemain or resort to transactions that provided one-shot improvements at the cost of longer-term problems. The important objective is meaningful and lasting reductions in the structural deficit. As long as the fiscal authorities adhere to this principle--be it through retention of Gramm-Rudman-Hollings or through some other mechanism--I believe that the financial markets will be reassured, interest rates likely will be lower than otherwise, and the prospects of achieving sustained, noninflationary economic growth will be enhanced.